NAME: _____

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ADVANCED AUDITING AND PROFESSIONAL ETHICS C.A. FINAL

EDITION - 1

CA NITESH KUMAR MORE

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This Book is dedicated to:

- ✓ MAA; who gave me darshan after SHAKTI PEETH PUJA at PANCHMUKHEE BALAJI DARBAR & PANCHMUKHEE BALAJI.
- ✓ My Gurus Sri Ramesh Chachan and Sri Sanjay Agarwal
- ✓ My Parents and All Family Members

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FOREWORD

CA. NITESH KUMAR MORE has been quite well-known in the Eastern region having contributed several papers and articles in various magazines and publications. Having gained the experience and conveying his valuable thoughts in various areas particularly on Auditing and Ethical Standards for Chartered Accountants it is very important that he has penned down all these in a comprehensive book Advanced Auditing and Professional Ethics. The present publication on this subject is not just another book for C.A. Final students but it is aimed at presenting the "Source Book" dealing with most essential aspect of auditing, which is fundamental to every Chartered Accountant. More than that the topics embodied and various issues covered on the subject of Professional Ethics are very applaudable. The requirement of adherence to professional ethics is the demand of the day. Our noble profession of Chartered Accountants has been well respected in the Society and very route and the basis of the same is strict adherence of the ethical standards. Various provisions of Chartered Accountants Act and Regulations are covered in interesting manner as applicable to members in practice as well as members in services. Both the topics are of great importance not only from the preparation for the final exams but also to equip students after they clear C.A. Final and are introduced in the Society as a fresh young Chartered Accountant. In India as well as in all other countries, the ethical standards and ethical values had played a very vital role and the author has covered all the issues and questions & answers in a most practical manner, which will prove to be a significant value addition to the students.

It has always been my conviction that it is upon an individual to create opportunity for himself or herself. Opportunity & Hurdle are two sides of the same coin. A situation that seems to be a hurdle to someone will be seen as an opportunity by someone else. Our attitude is what that matters.

Life is an opportunity for our evolution. Every moment is an opportunity to learn. Even an obstacle teaches us many useful lessons. What is required is our learning attitude. I am sure this book will develop attitude to learn more to all the readers & users.

The biggest and brightest opportunity that the Almighty has given us is to be part of the CA fraternity, the enlightened lot of people who are always admired for their cerebral powers. Let us utilize our talents and our powers for our overall holistic development. This book will certainly prove to be handy for such students who are going to be Future Chartered Accountants.

My hearty compliments once again to Nitesh Kumar More.

Ahmedabad
29th August, 2012

Sunil Talati

CA. Uttam Prakash Agarwal
B.Com, FCA, ICA (Australia), CPA (Australia)
Past President (2009-10) – The Institute of Chartered Accountants of India
Founder – Uttam Prakash Agarwal Shiksha Pariwar
Senior Partner – Uttam Abuwala & Co.
Chairman – Uttam Agarwal Corporate Advisory Private Limited

Message

I am glad to note that CA. Nitesh Kumar More, a young and dynamic Chartered Accountant, has authored this book for benefit of student's community and appreciate his efforts to repay the debt of the profession. I have gone through this book and found this to be very well presented with number of examples and illustrations. I think this will change the way my CA students study. This book is going to make studying a simpler and enjoyable process.

I have always worked for the benefit of our students and now I embrace the efforts of CA. Nitesh Kumar More in putting his valuable time and energy in this book. I hope this book would serve as an asset for every CA student.

My best wishes to him for all his present and future endeavours.

CA. Uttam Prakash Agarwal
29th August 2012

L B Jha & Co
Chartered Accountants

8, N. S. Road
Kolkata - 700001

Message

Dear Mr. More,

Your book on auditing is well written in language easy to understand. It takes a structured and systematic view of the subject and builds up the knowledge of students step by step.

I think this will be a good addition to the text books available for students on auditing.

Please continue writing as you are making an immense contribution in disseminating knowledge.

With best wishes,

Yours Sincerely,

Dipankar Chatterji
August 28, 2012

Preface to the FIRST Edition

Dear Friends,

The study material of the ICAI is like a bible. This book is not a substitute for study material. This book has been prepared to provide students a tool for systematic revision. The salient features of the book are:

- ✓ Questions and Answers from Latest Revision Test Papers (RTP).
- ✓ Case Studies – More than 180.
- ✓ Tabular Presentation – More than 40.
- ✓ Point wise Presentation (For Quick Revision Before Exams)
- ✓ Important Words – Bold (For Quick Revision Before Exams)
- ✓ Past Exam Questions with Marks and Years.
- ✓ Question Papers of Last 2 Terms.
- ✓ Latest RBI Guidelines (July 2012) & Latest Court's Decision.

My special thanks to Abhishek Bathwal (A CA Final Student), for providing valuable support for the publication.

I look forward for your valuable suggestions and criticism, if any.

Thanks and Warm Regards,

Dated: 29th July 2012
Place: Kolkata

CA Nitesh Kumar More
moreassociate@gmail.com

About The Author:

CA NITESH KUMAR MORE

- ✓ Has been a Co-opted Member of Permanent Research Committee of ICAI (EIRC).
- ✓ Has been a Co-opted Member of Internal Audit Committee of ICAI (EIRC)
- ✓ Has Contributed/Written more than 35 Write-ups/ Article in various magazines such as the Management Accountant, Suchitra Times, EIRC Newsletter, EIRC Members Ready Referencer, EIRC Conference etc.
- ✓ He is Providing Services to Many Corporate and Other Clients.
- ✓ Presented a Paper on Recent Changes in Direct Tax at CA Student Conference held at Kolkata.
- ✓ Stood 1st in Quiz Contest held at ICAI (Kolkata).
- ✓ Winner of 'Essay Writing Contest' organized by ICAI (EIRC).

LIST OF ABBREVATIONS USED IN THIS BOOK

AGM	Annual General Meeting	**JA**	Joint Auditors
AS	Accounting Standard	**JV**	Joint Ventures
BOD	Board Of Directors	**MD**	Managing Director
CAAT	Computer Assisted Audit Techniques	**MIS**	Management Information System
CAG	Comptroller & Auditor General Of India	**MRL**	Management Representation Letter
CG	Central Government	**NPA**	Non Performing Assets
CIS	Computer Information System	**NTE**	Nature Timing And Extent
CLB	Company Law Board	**PAC**	Public Account Committee
CR	Control Risk	**PFI**	Prospective Financial Information
DD	Due Diligence	**PRB**	Peer Review Board
DR	Detection Risk	**PSU**	Public Sector Unit
DSS	Decision Support System	**PU**	Practice Unit
DSS	Electronic Data Interchange	**QC**	Quality Control
EP	Engagement Partner	**RAP**	Risk Assessment Procedures
ESB	Ethical Standard Board	**SA**	Standard On Auditing
FRF	Financial Reporting Framework	**SG**	State Government
FS	Financial Statements	**SQC**	Standard On Quality Control
FY	Financial Year	**SR**	Special Resolution
GAAP	Generally Accepted Accounting Principles	**TCWG**	Those Charged With Governance
GIC	General Insurance Company	**W.E.F**	With Effect From
GM	General Meeting	**W.R.T**	With Regard To
IC	Internal Control	**WTD**	Whole Time Director

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1. PROFESSIONAL ETHICS

1.1 The Chartered Accountants Act, 1949 There are **two classes** of members,
(i) Those who are in practice and **(ii)** those who are otherwise occupied.
i) Members Who Are Deemed To Be In Practice: Sec 2(2) - In Section 2(2) of the Act, the term "**to be in practice**" has been defined as follows: -
"A member of ICAI shall be deemed "to be in practice" when individually or in partnership with CAs in practice, he, in consideration of remuneration received or to be received-
a. Engages himself in the practice of **accountancy**; or
b. Offers to perform or performs service involving the **auditing or other related services** or holds himself out to the public as an accountant; or
c. Renders professional services or assistance in **accounting procedure**.
d. Renders **such other services** as, in the opinion of the **Council** may be rendered by CA in practice.

ii) Explanation - An associate or a fellow of the Institute who is a **salaried employee** of a CA in practice or a firm of such CAs shall be deemed to be in practice for the limited purpose of the **training of Articled Clerks**".

The Council has passed a **resolution** permitting a CA in practice to render entire range of **"Management Consultancy and other Services"** which shall include the following:
a. Financial management planning
b. Capital structure planning
c. Working capital management
d. Preparing project reports and feasibility studies.
e. Preparing cash budget, cash flow statements, profitability statements, statements of sources and application of funds etc.
f. Budgets (capital and revenue).
g. Inventory management, material handling and storage.
h. Market research and demand studies.
i. Price-fixation and other management decision making.
j. Management accounting systems, cost control and value analysis.
k. Control methods and management information and reporting.
l. Personnel recruitment and selection.
m. Setting up executive incentive plans, wage incentive plans etc.
n. Management and operational audits.
o. Valuation of shares & business and advice regarding amalgamation, merger & acquisition.
p. Business Policy, corporate planning, organization development, growth & diversification.
q. Organization structure & behavior, development of human resources including design & conduct of training programmes, job-description, job evaluation & evaluation of workloads.
r. Systems analysis and other professional services relating to EDP.
s. Acting as advisor or consultant to an issue (but not activities of broking, underwriting and portfolio management)
t. Investment counseling
u. Acting as registrar to an issue and for transfer of shares/other securities.
v. Quality Audit.
w. Environment Audit.
x. Energy Audit.
y. Acting as Recovery Consultant in the Banking Sector.
z. Insurance Financial Advisory Services including Insurance Brokerage.

Above expression "Management Consultancy and other Services" excludes:
• Statutory, periodical audit. Tax representation or advice on tax matters.
• Acting as liquidator, trustee, executor, administrator, arbitrator or receiver.
The act of setting up of an establishment offering to perform accounting services would tantamount to being in practice even though **no client has been served**.
A member of the Institute is deemed to be in practice during the period he renders 'service with armed forces'.

iii) A member of the Institute is also deemed to be in practice when he accepts any one of following in his **professional capacity:**
a. Liquidator, trustee, executor: administration, arbitrator, receiver, advisor or representation for costing, financial or taxation matters, or
b. Appointment by C.G. or S.G. or court or legal authority, or
c. Act as a Secretary
But if such appointment is on **salary cum full time basis** he is not deemed to be in practice.

1.2 Significance Of The Certificate Of Practice – A member who is not in practice is precluded from accepting engagement to render services of any of the types normally prescribed for a CA, even though for doing so, he does not require special qualifications. The Council of the institute is of view that:
i) Once the person concerned becomes a member of The Institute, he is bound by the provisions of the CAs Act and its Regulations.
ii) A member of the Institute can have no other capacity in which he can take up such practice, separable from his capacity to practice as a member of the Institute."

1.3 Disabilities For Purpose Of Membership (Section 8)
i) Age less than 21 years at time of application, or
ii) Unsound mind as per a competent court, or
iii) Undischarged insolvent, or
iv) Discharged insolvent but has not obtained a certificate from court stating that his insolvency was due to misfortune without any misconduct on his part, or
v) Convicted by competent court of offence involving moral turpitude, or offence not of technical nature, committed by him in his professional capacity. But this disqualification is not attracted if he has been granted a pardon or GC has removed his disability.
vi) Removed from membership by ICAI due to misconduct.
If he fails to disclose his disabilities to ICAI, it would constitute professional misconduct.

1.4 "Professional Misconduct" - For the purpose of this Act, the expression "professional or other misconduct" shall be deemed to include any act or omission provided in any of the Schedules, but nothing in this section shall be construed to limit or abridge in any way the power conferred or duty cast on the Director (Discipline) under subsection (1) of section 21 to inquire into the conduct of any member of the Institute under any other circumstances.

Other Misconduct - A member is liable to disciplinary action under Section 21 of the CAs Act, if he is found guilty of any professional or "Other Misconduct". Other misconduct has been defined in part IV of the First Schedule and part Ill of the Second Schedule. As per part IV of the First Schedule to the CAs Act, A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he -
i) Is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not exceeding six months;

ii) In the opinion of the Council, brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work.
This provision empowers the Council to inquiry into any misconduct of a member even it does not arise out of his professional work. This is considered necessary because a CA is expected to maintain the highest standards of integrity even in his personal affairs arid any deviation from these standards, even in his non-professional work, would expose him to disciplinary action. For example, a member who is found to have forged the will of a relative would be liable to disciplinary action even though the forgery may not have been done in the curse of his professional duty.
Other misconduct would also relate to conviction by a competent court for an offence involving moral turpitude punishable with cause transportation or imprisonment to an offence not of a technical nature committed by the member in his professional capacity.

Some examples, where a member may be found guilty of "Other Misconduct", under the aforesaid provisions rendering, himself unfit to be member are:
i) Where a CA retains the books of account and documents of the client and fails to return these to the client on request without a reasonable cause.
ii) Where a CA makes a material misrepresentation.
iii) Where a CA uses the services of his articled or audit clerk for purposes other than professional practice.
iv) Misappropriation by office-bearer of a Regional Court of the Institute, of a large amount and utilization thereof for his personal use.
v) Non-replying within reasonable time & without good cause to letter of public authorities.
vi) Where certain assessment records of income tax department belonging to the client of CA were found in the almirah of the bed-room of the CA.
vii) Where CA had adopted coercive methods on a bank for having loan sanctioned to him.

1.5 Penalty For Falsely Claiming To Be A Member (Section 24)
i) Any Person shall be penalized if he:

Not being a C.A	Being C.A. not having COP
Represents that he is CA	Represents that he is in Practice
Uses designation CA	Practices as a CA

ii) Penalty:

1st conviction	Subsequent Conviction
Fine up to 1000	Fine up to 5000 'or' Imprisonment up to 6 months 'or' Both

1.6 Section 27: Maintenance of Branch Offices by a Practicing Member - Office is a place where name board of firm is affixed, or which is described as place of business on professional stationery.
• **Is name board at home allowed?**
• **Name board of firm - No,** because otherwise it is deemed to be as office.
• **Name board of himself – Yes,** containing his name, degree and designation CA
• **How many branch offices he can open -** Any number provided each branch must have separate C.A. in charge Or Partner In whole time employment of C.A. concerned
• **Meaning of in charge -** Who either attends the said office or resides in the city where such office is situated, at least for 182 days in a year.

i) Temporary Office
a. For members practicing in hilly areas &
b. Temporary office may be opened in plains in winter season only for 3 months
c. Temporary office not to be mentioned as place of business on professional stationery, &

d. Correspondence may continue at permanent office, &
e. Before coming to plains & at close of such temporary office inform ICAI, &
f. Name board of firm to be displayed at temporary office only during these 3 months.

ii) Second Office - If it is situated:
a. In same premises in which first office is situated; or
b. In the same city; or
c. Within 50 kms from municipal limits of city in which first office is situated*

1.7 Misconduct

SCHEDULE	
First Schedule (refer to board of discipline)	**Second Schedule (refer to disciplinary committee)**
Part 1 - (12 clauses) - Proof. Misconduct - C.A. in practice	Part I - (10 clauses) Professional Misconduct - C.A. in practice
Part II - (2 clauses) Professional Misconduct - C.A. in service	Part II - (4 clauses) Professional Misconduct - C.A. generally
Part III - (3 clauses) Professional Misconduct - C.A. generally	Part III - Other Misconduct
Part IV - Other Misconduct	

Easy learning of CLAUSES of PROFESSIONAL ETHICS

PART 1 of SCHEDULE 1: KEY:
"Nana Patekar Asks Partner Shilpa Shetty About C.A. Prospectus Being in South"

Clause: 1 Nana - Name
Clause: 2 Patekar - Pays
Clause: 3 Asks - Accepts
Clause: 4 Partner - Partnership
Clause: 5 Shilpa - Secures
Clause: 6 Shetty - Solicits
Clause: 7 About - Advertises
Clause: 8 C. - Communicating
Clause: 9 A. - Ascertaining
Clause: 10 Prospectus - % of Profit
Clause: 11 Being in - Business or Profession
Clause: 12 South - Sign on his behalf

PART 1 of SCHEDULE 2: KEY:
"Don't Cheat Friends it May Make Good Intention Go Bad"

Clause: 1 Don't - Disclosure
Clause: 2 Cheat - Certifies
Clause: 3 Friends - Forecast
Clause: 4 Partner it - Partnership Substantial Interest
Clause: 5 May - Material Fact
Clause: 6 Make - Material Misstatement
Clause: 7 Good - Grossly Negligent
Clause: 8 Intention - Sufficient Information
Clause: 9 Go - Generally Accepted
Clause: 10 Bad - Separate Bank Account

PART – I of THE FIRST SCHEDULE (Refer to Board of Discipline)
"Professional misconduct in relation to CA in practice"

A CA in practice shall be deemed to be guilty of professional misconduct, if he -

Clause 1 - Allows any person to practice in his name as a CA
Exception: such person is a CA in practice & is a partner or an employee (both cumulative).
Example: A CA Firm, XYZ & Co. having 3 partners, X, Y and Z & its CA employee is Mr. P anybody other than X, Y, Z, and P can't practice as C.A. If Mr. X allows Mr. V who is a law graduate to practice in said firm as a C.A., Mr. X would be guilty.
Comment of Author: The objective of this clause is to prevent unqualified persons from acting as CAs.

Clause 2 - Pays or allows or agrees to pay or allow, directly or indirectly, any share, commission or brokerage in the fees or profits of his professional business, to any person
Exception: CA or a **partner** or a **retired partner** or the **legal representative** of a deceased partner, or a **member of any 'other professional body'*** or with **such other persons** having '**prescribed qualifications'****** for the purpose of rendering such professional services from time to time in or outside India.
Explanation: "partner" includes a person residing outside India with whom a CA in practice has entered into partnership which is not in contravention of item (4) of this Part;
Comment of Author: The objective of this clause is that he should get his professional work due to his own competent but not through services of agent or third parties.

***'Other professional bodies'** have been notified by the council are ICSI, ICWAI, Bar Council of India, The Indian Institute of Architects and The Institute of Actuaries of India.
****'prescribed qualifications in India'** are CS, CWA, Actuary, Bachelor in Engineering, Bachelor in Technology, and Bachelor in Architecture, Lawyer, and MBA.

Important Points:
i) In case of sole proprietorship firm, widow of deceased can sell goodwill of the firm to another eligible CA. However, there could not be any sharing of fees between legal representative of sole proprietorship firm and the purchaser of goodwill. Such payment can be made in installment also if agreement of sale of goodwill provides so. The firm name will be kept in abeyance by ICAI for 1 year so that widow can sell goodwill.
ii) In case of Partnership firm, A widow of deceased can receive share of firm only if partnership agreement provides for such provision otherwise not.
iii) CA in practice should **not extend his service** beyond the orbit of his professional practice when working in **association with other professionals** on a project**.**
iv) It is not the nomenclature to a transaction that is material but it is the **substance of the transaction**, which has to be looked into. Example, A CA gave 50% of the audit fees received to the complainant, who was not a CA, under the nomenclature of office allowance, it was held by the Council that in substance the CA had shared his profits and therefore was guilty of professional misconduct under the clause.

Clause 3 - Accepts or agrees to accept any, part of the profits of the professional work of a person who is not a member of the Institute:
Exception: A member of any 'other professional body'* or with such other persons having 'prescribed qualifications'** (For explanation refer Clause 2 above)
Comment of Author: The objective of this clause is to restrain a member from sharing the profits of the professional work with non member and/or other non prescribed person.

Clause 4 - Enters into partnership, in or outside India, with any person
Exception:
a) CA in practice or
b) `**Member of other professional body**'* having prescribed qualifications.
c) A person resident without India who but for his residence abroad (i.e. A CA residing abroad) would be entitled to be registered as a member u/s 4 (i) (v) or
d) A person Whose qualifications are recognized by the CG or the **Council**** for the purpose of permitting such partnerships?

***`Member of other professional bodies**' are CS, CWA, Advocate, Engineer, Architect, Actuary, Professional bodies outside India whose qualification are recognized by council. The Council had not recognized membership of any bodies for the purpose of permitting partnerships by Indian Nationals abroad as are referred to in this clause:

Important Points:
i) The provisions of the CAs Act, 1949 are not applicable outside India. So, if an Indian CA **practicing outside India** enters into partnership with other person outside India then he is not guilty. However, if an Indian CA **practicing in India** enters into an agreement with other person outside India then he will be guilty.
ii) Where a CA had engaged himself as a **partner in two business firms** and Managing Director in two Companies and was also holding Certificate of Practice without obtaining permission of the Institute. Held that he was a guilty of professional misconduct inter alia under Clauses (4) and (11)

Clause 5 - Secures, either through the services of a person who is not an **employee** of such CA or who is not his **partner** or by **means** which are **not open to a CA**, any professional business:
Exception: any arrangement permitted in terms of clauses (2), (3) and (4) as above;
Comment of Author: The objective of this clause is that he can get professional work through partner or employee, but not services of agent or third parties.

Clause 6- Solicits clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means.
Exception:
(i) he can apply or request or secure professional work from another CA in practice; or
(ii) respond to tenders or enquiries issued by various users of professional services or organizations from time to time and securing professional work as a consequence;
Comment of Author: This clause elaborates clause 5

Guidelines For Permitting To Post Their Particulars At Website
Permitted Features
i) C.A. / CA firms are free to create website.
ii) It can be in **any format color** as per taste of CA.
iii) CA can mention website address on professional stationery.
iv) Website should be run on pull mode (i.e. should be accessible only to the person who specifically requests for access) not in push mode. **(May 2007)**

Prohibited information - They can't provide on website
i) Name of clients & fee charged
ii) Logo (other than that prescribed by ICAI)
iii) No photograph (**other than passport size** photo of member) **(May 2005)**
iv) No advertisement.
v) No reference of any other website (other than ICAI/ govt. related)

Permitted information within CA's website

i) Name of member/ firm
ii) Member's/ firms address/ telephone no. / fax/ e-mail Id
iii) Partners' name & their qualifications, year of qualification, home address, telephone no., e-mail Id. (**i.e. Bio-Data of partner)**, **(May 2005)**
iv) Employee's names and their qualifications
v) Job vacancies including article ship,
vi) Passport -size-photograph of members.
vii) Reference about ICAI/govt. related website.
viii) Articles etc. of professional interest such as budget highlights.
ix) Bulletin board.
x) Chat rooms between client & C.A. or among CA's. However confidentiality should be maintained.
xi) Date up to which website is updated.
xii) Common logo prescribed by ICAI.

Within website specific pull request for

i) Nature of services rendered
ii) Nature of assignment handled
iii) Area of expertise of partners
iv) Area of expertise of employees
v) No. of articled clerks
vi) Year of establishment.

Other issues relating to website

i) Address of website - Website address should be in the name of C.A. /C.A. firm.
• It may be different from firm? C.A. name but should be as near as possible to their name.
• Address should not be such as results in soliciting the client.
ii) Search Engine
• Listing of CA's website on search engine is allowed**.**
• But it should be on criteria such as CA, Indian CPA or any related field.
iii) Hyperlinks - In CA's website, link/reference of only ICAI related or govt. related website is allowed. **(May 2006)**
iv) Intimation ICAI - Presently, CA is required to inform website address to ICAI. While submitting annual membership fee and form (as per old provision, it was required to intimate ICAI within 30 days of setting up website. But now the same has been changed)
v) Services through other websites is allowed; provided contact address, firm name & professional achievement of CA is not given. Only CA's name with designation 'CA' is allowed.

Important Points:

i) Empanelment for allotment of audit professional work.

Permitted Features:

a. C.A's can write to concerned organization for having their name on **panel maintained** by such organizations (For e.g. - Empanelment by RBI for Bank Audits)
b. CA can quote fee only if enquired by such organization.

Prohibited items:

a. Roving enquiries cannot be made such as whether the organizations maintain penal or not and enquiring why work is not being allotted to him although his name is on the panel.
b. CA can't send Printed/Cyclostated copies of fee in reply.
c. Not allowed to respond to empanelment requiring registration fee.

ii) Publication in telephone/other directories

Permitted Features - They can have their name included in telephone/ trade directories if following are satisfied:

a. Entry in separate section of CA.
b. Entry in normal types of letters (Not Bolder).
c. It should appear in the local directory of the city in which concerned CA/firm practices.
d. Entries should be in logical (alphabetical) order.
e. Payment for entries should be reasonable.
f. Entries should be open to all CA's.

Prohibited items

a. No impression of publicity or advertisement.
b. No special request or additional payment by C.A. is allowed.

iii) Issuing hand bills

Permitted - He can distribute hand bills containing their name to his clients (For e.g. Budget highlights).

Prohibited – He cannot issue hand bills to any other person other than client.

iv) Publication of books or articles

Permitted

a. CA in practice can write books etc. & get them published.
b. Can mention his name & his personal/ academic details. **(May 2005)**

Prohibited - But no mention of firm name

v) Issue of greeting card/invitations

Permitted - CA can indicate designation, name of firm and address on Greeting cards or Invitation for **(a)** Marriage, **(b)** Religious ceremonies, **(c)** Inauguration of office, **(d)** Letters regarding change in office.

Condition - Provided (a) to (c) is sent only to clients, relatives & close friends.

vi) Scope of representation u/s 225 (3)

Representation when

a. The auditor who is being removed in GM, has right of representation.
b. He may indicate in his letter his willingness to continue as auditor if shareholders in AGM decide so, but this should not be in the nature of solicitation.

Prohibition

a. But there should not be any extra publicity therein.
b. No derogatory, unsubstantiated remarks against the management of Co. **(May 1997)**
c. it should highlight contribution made by CA to the company **(Nov 2001)**

vii) Acceptance of professional work emanating from a client introduced by another CA. - The Council has decided that a member should **not accept** the original professional work emanating from a client introduced to him by another member. If any professional work of such client comes to him directly, it should be his duty to ask the client that he should come through the other member dealing generally with his original work.

viii) Public Interview - Due care should be taken to ensure that such interviews or details about the members or their firms are not given in a manner highlighting their professional attainments. As per example, it should not detail the achievement of the concerned person/firm or its partner and his recognition in the particular field. **(Nov 2001)**

ix) Advertisement under box Number – Prohibited

x) As per guidelines for responding to tenders if a matter relates to any service other than audit, members can respond to any tender. Further in respect of non exclusive area, members are permitted to pay reasonable amount towards earnest money/security deposit **(May 2006)**

Some Of The Decisions Of Supreme Court/ High Court/Council
Guilty:
i) Where a CA wrote to the Ministry of Commerce and Industry to enroll the name of his firm in the **list of auditors** maintained by the Department (Case of K.C.J. Satyawadi)
ii) A member was found **guilty** for having issued **'circular letters'** regarding change of address of his firm to persons who were not in professional relationship with him and for having **written to shareholders thanking** them for appointing him as an auditor. (K. K. Mehta V. M. K. Kaul)
iii) An advertisement was published in a newspaper containing the member's photograph wherein he was **congratulated on the occasion of opening ceremony** of his office. (Case of G. P. Agarwal)
iv) Where a CA had sent a letter to another firm of CA in which he had introduced his **pioneer in liasoning** with CG ministries and its allied departments for getting various Government clearances for which he had claimed to have expertise and had given the list of his existing clients and details of his staff etc. (Case of Bijoy Kumar)
v) Where a CA sent a **printed card and circular letters** soliciting work. Held, he was guilty under the clause. (M.J. Gadre vs. W.G. Ambekar) **However,** if printed cards or circulars letters are sent by following the **advertisement guidelines 2008,** then he will not be guilty.
vi) A member had published an advertisement, in a newspaper inviting professional work for accounts writing, Income tax matters etc. It was held that the insertion of an advertisement of such a nature amounted to soliciting professional work by advertisement and the member was found guilty in terms of this Clause. (Vallabh C. Shah) **However,** if printed cards or circulars letters are sent by following the **advertisement guidelines 2008,** then he will **not be guilty**.

Not Guilty:
i) It was held that writing letters to **current auditors** by CAs offering their services to audit the accounts was **not guilty** as it was an offer to a professional colleague and not to a prospective client. (Case of M. N. Agarwal)
ii) Where a CA firm issued a letter of authority in favour of two other CAs to accept and carry out audits of Co-operative Societies on its behalf and CAs issued circulars of which the firm was not aware - Held, that the firm was not guilty of professional misconduct. (V.B. Kirtane) But the person, in whose favour the letter of authority was given in the above case, was held guilty. (MR Walke)

Clause 7 - Advertises his professional attainments or services, or uses any designation or expressions other than CA on professional documents, visiting cards, and letter heads or sign boards.
Exception:
i) Degree of a University established by law in India, or recognized by the CG or a title indicating membership of the Institute of CAs of India or of any other institution that has been recognized by the CG or may be recognized by the Council:
ii) A member in practice may advertise through a write up, setting out the services provided by him or his firm and particulars of his firm subject to **such guidelines** as may be issued by the Council.

Guidelines For Advertisement For The Members In Practice

i) The write-up may include only the following information:

a. For Members: Name, Membership No., Age, Date of becoming ACA, Date of becoming FCA, Date from which COP held, Recognized qualifications, Languages known, Telephone/Mobile/Fax No., Professional Address, Web, E-mail, CA Logo, Passport size photograph, Services provided, Names and details of the employees and their particulars on the lines allowed for a member as stated below.

a. CAs, **b.** Other Professionals, **c.** Articles/Audit Assistants, **d.** Other Employees.

b. For Firms: Name of the Firm, Firm Registration No., Year of establishment, Professional Address, Working Hours, Tel. No(s)/Mobile No./Fax No, Web address, E-mail, No. of partners, CA Logo, Passport size photograph, Services provided, Name of the proprietor/partners and their particulars on the lines allowed for a member as stated above, Names and details of the employees and their particulars on the lines allowed for a member as stated **a.** CAs, **b.** Other Professionals, **c.** Articles/Audit Assistants, **d.** Other Employees.

ii) The write-up may have the Signature, Name of the Member/ Name of the Partner signing on behalf of the firm, Place and Date.

iii) Other Conditions: The write should not:

- contain **false or misleading information** and bring the profession into disrepute.
- claim **superiority** over any other Member(s)/Firm(s)
- be indecent, **sensational** or otherwise of such nature which may likely to bring the profession into disrepute.
- contain **testimonials** or endorsements concerning Member(s).
- contain any **other representation**(s) that may like to cause a person to misunderstand and/or to be deceived.
- **violate** the provisions of the 'Act', Rules made there under and 'The CAs Regulations, 1988.
- include the **names of the clients** (both past and present)
- be of **font size** exceeding 14.
- contain any information **other than stated in Para 3** hereinabove.
- contain any information about **achievements / award** or any other position held.

Important Points:

i) Advertisement in press – refer guidelines for advertisement for members in practice.

ii) Appearance on TV/films/radios/press/seminars-

a. They may appear

b. May describe themselves as CA

c. But no reference as to name/address/ services of firm

d. He should not say anything to promote him/his firm. Whatever he says, must be professional & objective.

e. It is the duty of CA concerned to ensure that even host should not refer to such thing.

iii) Photograph & brief particulars of CA in magazine - Allowed provided

a. no payments is made for such publication and

b. no mention of professional attainments

iv) Training courses and Seminars - A CA holding training courses, seminars etc. for his staff may also invite the staff of other professional accountants and clients to attend the same. However, undue prominence should not be given to the name of the CA in any booklet or document issued in connection herewith.

v) Publicity for appointment of position of local/ national importance - Permitted
a. They may mention membership of ICAI.
b. But no mention as to firm name.

vi) Prospectus of company in which CA is director
a. CA's name address in the capacity of director is allowed in prospectus.
b. But no firm name.
c. No expression like "Associates of……..."
d. No advertisement of professional achievement. **(May 2002)**

vii) Press note on success of a candidate in exams – Permitted - It may contain
a. His name & address his background **b.** His success details **c.** Name & firm of his principal
But there should not be any undesirable publicity of Article/Principal/Firm.

viii) Sign Board
a. Can't use glow sign board or large sized sign boards.
b. At residence, name board of himself is allowed but not that of firm

ix) Date of establishment of firm - Can't provide on letterheads etc.
Exception - Website

x) Designation
a. Only CA
b. Only on professional documents, visiting cards, letter heads, sign boards or where stated in clause 6 (e.g. - greeting cards)
c. Can't use words like income tax consultant, cost consultant or management consultant etc **(May 2000)**
d. However there is no provision for printing the names of three firms on the personal letterhead **(June 2009 New)**

xi) Listing in directory or list of members of particular body
a. Allowed
b. It may contain his/ his firm's name and address
c. Names of members in such directory should be in logical order.
d. He may provide directorships held, reasonable personal details & outside interest.
e. But can't provide names of clients & services offered by his firm.
For e.g. - In list of members of Income Tax Appellate Tribunal, When CA concerned is a member of ITAT.

xii) Logo - A common logo is prescribed by ICAI. C.A. cannot use any other logo.

xiii) If he is Member of Parliament or any elected authority - Can't use Member of Parliament or any other such designation in addition to CA.

xiv) If he is advocate as well - Can't use advocate in addition to CA' (for details refer to Section 7)

Guidelines for Members Holding Certificate of Practice on acceptance of directorships in companies: Such prospectus or public announcements or public communications do not advertise his professional attainments and also that such prospectus or public announcements or public communications do not directly or indirectly amount to solicitation of clients for professional work by the member. The member must ensure that descriptions about his expertise, specialization and knowledge in any particular field of other

appellation or adjectives are not published with his name. Particulars about directorships held by the member in other companies can, however, are given, but the name of the Firm of CAs in which the member is a partner, should not be given.

Guidelines for use of expressions such as Associates of etc.: The use of expressions / words in Association with 'Associates of 'Correspondents of etc., on the stationery letter heads, visiting cards and professional documents etc. of firms of CAs is **not permissible** in view of the provisions of clause (7) of Part I of the First Schedule to the CAs Act, 1949 **irrespective** of whether the connection bearing name sought to be used was the name of an **Indian firm or a foreign firm**. The Council has **not barred entering into such association** and the restriction given under the above clause is to bar an advertisement appearing/derived from such associations.

Clause 8 - Accepts a position as auditor previously held by another CA or a certified auditor without **first communicating with him in writing;**

The Council Has Also Laid Down The Detailed Guidelines On The Subject As Under:
i) The requirement for communicating with the previous auditor being a CA in practice would apply to **all types of audit** viz., statutory audit, tax audit, internal audit, concurrent audit or Vat audit any other kind of audit of both government and non-government entities. **(May 2003, May 2008)**
ii) The term **"previous auditor"** means the **immediately preceding auditor** who held same or similar assignment comprising same/similar scope of work.
iii) A communication is mandatorily required for **all types of audit/report** if the previous Auditor is a CA. **For certification**, it would be healthy practice to communicate. In case of **assignments done by other professionals** not being CAs, it would also be a healthy practice to communicate.
iv) In case the **time schedule given for the assignment** is such that there is no time to wait for the reply from the outgoing auditor, the incoming auditor may give a **conditional acceptance** of the appointment and commence the work which needs to be attended to immediately after he has sent the communication to the previous auditor in accordance with this clause.

Important Points:
i) Professional reasons for not accepting audit
a. Non-compliance of provisions of Section 224 & 225 of Companies Act.
b. Non-payment of undisputed audit fee (**except sick units**)
c. Issuance of qualified report
d. Under cutting of fees

ii) Should he accept?
In first two i.e. (a) & (b) He **can't** accept
In (iii) he **may accept** if he thinks that attitude of retiring auditor wasn't proper & justified.

iii) Dispute between client & retiring auditor regarding fee - Incoming auditor should use his influence in favor of his predecessor to have dispute settled.

iv) How to communicate? - By R.P.A.D (Registered Post Acknowledgement Due) or by hand against an acknowledgement in writing and not under certificate of posting as he must have **positive evidence** that the latter has infect reached the previous auditor/his predecessor **(Nov 1996, Nov 2003, June 2009)**

v) Duty of outgoing auditor - He must reply as early as possible. However if he does not reply, he may act after waiting for **reasonable time.**

vi) Responsibility of incoming auditor when prospective client tells him about change of auditor

<table>
<tr><th colspan="3">Ask client whether previous auditor has been informed</th></tr>
<tr><th>If yes</th><th colspan="2">If no</th></tr>
<tr><td rowspan="3">Communicate with Previous auditor</td><td colspan="2">Ask client reason for change</td></tr>
<tr><td>Valid reason</td><td>No valid reasons</td></tr>
<tr><td>He may accept but after communication with predecessor</td><td>Healthy practice not to accept</td></tr>
</table>

Comment of Author - It is professional courtesy on part of incoming auditor to know the reason for change or any objections from the retiring auditor.

Clause 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 (1 of 1956) in respect of such appointment have been duly complied with. **(Nov 1999, Nov 2003)**
i) "**To ascertain**" means "to find out for certain" whether the company has complied with aforesaid provisions.
ii) It is **not sufficient** to accept compliance certificate from management but he has to verify the relevant records to ascertain whether the company has, in fact, complied with the provisions.
iii) He may **verify Board Resolution**, General Meeting Resolution, Special Resolution if provisions of section 224A is applied, CG approval, if auditor is to be removed before the expiry of his term of office. Records to see that notice have been sending within time specified. Copy of minutes of meeting where various resolutions are passed. If AGM is adjourned without appointment of auditors, then retiring auditors will continue till adjourned meeting and new auditors will assume office only after conclusion of adjourned meeting.
iv) A member had accepted appointment as auditor of a company **without ascertaining** from the company whether the requirements of section 224 and 225 of companies act had been complied with. However, he realized this defect **only after acceptance**.

Ethical Standard Board (ESB) –
i) In order to examine various ethical issues and safeguard the independence of the Auditors, the Council has set up an Ethical Standards Board (ESB).
ii) This Board examines various issues concerning professional ethics governing the members of the Institute which are either raised by the members or are taken up based on their importance.
iii) The recommendations of the Board are forwarded to the Council for its consideration.
iv) This Board is also charged with the responsibility of looking into the cases of removal and resignation of auditors and making an appropriate report to the Council.
v) The **following guidelines** have been issued for the Board for looking into the cases of Removal of Auditors:
a. Where an auditor **resigns** his appointment as an auditor of a Company or does not offer himself for reappointment as auditor of such Company, he shall send a **communication,** in writing, to the BOD of the Company giving **reasons** therefore, if he considers that there are professional reasons connected with his resignation or not offering himself for re-appointment which, in his opinion, should be brought to the notice of the BOD, and shall send a copy of such communication to the Institute. It shall be obligatory on **the incoming auditor**, before accepting appointment, to obtain a copy of such communication from the BOD and consider the same before accepting the appointment.
b. Where an auditor, though willing for re-appointment has not been reappointed, he shall **file with the Institute a copy of the statement** which he may have sent to the

management of the Company for circulation among the shareholders. It shall be obligatory on the **incoming auditor** before accepting the appointment, to obtain a copy of such a communication from the Company and consider it, before accepting the appointment.
c. The Ethical Standards Board, on a review of the communications referred to in Para (1) and (2), may call for **such further information** as it may require from the incoming auditor the outgoing auditor and the Company and **make a report** to the Council in cases where it considers necessary.
d. The above procedure is also followed in the case of removal of auditors by the **government and other statutory authorities.**

Clause 10 - Charges or offers to charge, accepts or offers to accept in respect of any professional employment, fees which are based on:
i) A **percentage** of profits or
ii) Which are **contingent** upon the findings, or results of such employment? **(Nov 1996, Nov 2001)**

Exception - Regulation 192:
i) A **receiver or a liquidator** can receive fees based on percentage of realization or disbursement of the assets.
ii) Auditor of co-operative society can receive fees based on paid up capital or working capital or gross or net income or profits.
iii) A **Valuer for direct taxes and duties** can charge fees based on percentage of the value of property valued. (**E.g.** – He can charge fees based on % of Value of Goodwill for determining value of gift under Gift Tax Act as gift tax is a direct tax)

Clause 11 - Engages in any business or occupation other than the profession of CA
Exception:
i) Unless **permitted by the Council** so to engage:
ii) director of a company (not being a MD or a WTD) unless he or any of his partners is interested in such company as an **auditor**.

Important Points:
i) CA in practice should **not accept** the directorship in any of its subsidiary or its holding company if he is the auditor of holding or its subsidiary company as it will affect his independence. **(May 2008)**

Regulation 190A - General permission - CA in practice may engage himself in following activities without obtaining any specific permission from council.
i) Employment under C.A. / C.A. firm.
ii) Private tutorship.
iii) Authorship of Books/Articles.
iv) Holding Life Insurance Agency license (only for limited purpose of getting Renewal Commission)
v) Attending class and appearing in any exams.
vi) Holding public elective office (M.P., M.L.A.)
vii) Honorary office of charitable - educational institute.
viii) Notary public, Justice of peace, Special Executive Magistrate and like.
ix) Part time tutorship under coaching organization of institute.
x) Valuation of paper, paper setter, head-examiner or moderator for any exam.
xi) Editorship of professional journal.
xii) Acting as Surveyor/Loss Assessor under Insurance Act.
xiii) Recovery consultant.
xiv) Insurance brokerage.

Regulation 190A - Specific permission - May engage himself in such activities only after obtaining prior & specific permission of council -

i) Full time/ Part time

a. Employment in **business** concerns provided he/his relative is not having substantial interest in such concerns. **(May 2003, May 2010)**

b. Employment in any **non-business** concern.

c. Lectureship for courses other than those relating to ICAI. **(May 2000)**

d. Tutorship under any educational institute other than coaching organization of ICAI.

ii) Interest in

a. Family business concern in which interest is due to relationships/inheritance provided no active part in its management is taken by CA concerned.

b. Educational institution

c. Agricultural/ allied activities carried on with help of hired labor.

iii) MD/ WTD of a company

Note - A person is deemed to be MD if he is entrusted with whole/ substantially the whole of management of affairs of the company. **(Nov 2000)**

iv) Editorship - of journal other than professional journals.

v) Any other business/profession - If executive committee considers that permission may be granted.

Regulation 191 - He may act as following provided his appointment is **not on salary-cum-full time basis.** Receiver, Liquidator, Executor, Trustee, Advisor, Administrator, Arbitrator, Representative for costing/taxation/financial matters, Appointment by CG/ SG/ Court/ Legal authority, Secretary

Some Of The Decisions Of Supreme Court/ High Court/Council

Guilty:

i) Where a CA while practicing as a CA had engaged himself in other occupation as an LIC agent in another name. Held that he was held guilty Clause (11) of schedule (C.I.T. (Admn.) vs. H.M. Giriya)

ii) Where a CA had offered to help the Complainant in disposing of odd lot share holding, sold them at much lower rate than he had sent of the Complainant notes etc and the said CA was personally involved in the share transfer and broker's business besides his profession activities.

Clause 12 - Allows a person not being a member of the Institute in practice, or a member not being his partner to sign on his behalf or on behalf of his firm, any balance-sheet, P&L A/C, report or financial statements.

Exception – Power to sign **routine documents (but not reports)** may be delegated to assistants where professional opinion is not required. However, the fact that the documents have not been signed by a CA is **not a defence** to him or to the firm in an enquiry relating to **professional misconduct. (May 1990, May 1991, May 2007)**

The **Council** has decided that where a CA while signing a report or, a financial statement or any other document is **statutorily** required to **disclose his name**, the member should disclose his name while appending his signature on the report or document. Where there is no such statutory requirement, the member may sign in the name of the firm.

PART – II of THE FIRST SCHEDULE
"Professional misconduct in relation to members of the Institute in service"

A member of the Institute (other than a member in practice) shall be deemed to be guilty of professional misconduct, if he being an employee of any company, firm or person -
Clause 1 - Pays or allows or agrees to pay directly or indirectly to any person any share in the emoluments of the employment undertaken by him;

Clause 2 - Accepts or agrees to accept any part of fees, profits or gains from a lawyer, a CA or broker engaged by such company, firm or person or agent or customer of such company, firm or person by way of commission or gratification. **(Nov 2000)**

PART – III of THE FIRST SCHEDULE
"Professional misconduct in Relation of members of the Institute, generally"

A member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he -

Clause 1 - Not being a fellow of the Institute, acts as a fellow of the Institute.

Clause 2 - Does not supply the information called for, or does not comply with the requirements asked for, by the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline, Disciplinary Committee, Quality Review Board or the Appellate Authority. **(May 2001, May 2010)**

Clause 3 - While inviting professional work from another CA or while responding to tenders or enquiries or while advertising through a write up or anything as provided for in items (6) and (7) of Part I of this Schedule, gives information knowing it to be false.

Some Of The Decisions Of Supreme Court/ High Court/Council
i) An **article clerk** while undergoing his articles was also in **whole time employment** elsewhere without the permission of Council. There was evidence that member under whom he was undergoing his articles was aware of this. The member was found guilty so far as:
a. He allowed the article to work elsewhere without permission of the Council; and
b. Failed to disclose this fact in Form No. 16. (Case of N. K. Gupta)
ii) Where a CA who was **suspended for six months** from practice by an order of the High Court, failed to return the COP, when directed to do so by the Institute. The Council treated it as information and proceeded against him under the clause. Held, that no misconduct has been established against the CA. (Case of A. C. Kher)
iii) Where a CA had **continued to train** an articled clerk, though his name was removed from membership of the Institute and he had **failed to send a reply** to the Institute asking him to send an explanation as to how he was training his articled clerk when he was not a member. Held he was guilty under the clause. (Case of S. M. Vohra)

PART – IV of THE FIRST SCHEDULE
"Other misconduct in relation to members of the Institute generally"

Clause 1 – CA is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term not **exceeding six months**;

Clause 2 - In the opinion of the Council, brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work.

For example -
i) Use of article clerk for personal work.
ii) Misappropriation of ICAI's money by a member of council.
iii) Dishonor of cheque issued by CA.

PART - I of THE SECOND SCHEDULE
"Professional misconduct in relation to CA in practice"

Clause 1 - Discloses information acquired in the course of his professional engagement to any person other than his client so engaging him **(May 2000, May 2004)**
Exception –
i) Permitted by Client
ii) Required by any law

Duty in relation to unlawful acts by client - General Rules
i) There is no duty to **inform tax authorities** about tax frauds by his client.
ii) It is also not duty of C.A. to **shield him from consequences** of frauds.
iii) His responsibility is to advise client in a persuasive way not **to** involve in tax frauds by impressing upon him that:
a. Disclosure by client may entail only penalties but **non-disclosure** may result even in imprisonment.
b. If C.A. informs tax authorities about his **disassociation from matter**, authorities may start investigation.
c. In case of **genuine mistake** client will himself disclose.

Summons - If tax authorities summon C.A. for examining him on oath or for production of books of accounts, he should take **legal expert opinion**.

Fraud Relates To			
Past Year's Return/Accounts		**Current Year's Return/Accounts**	
Where client was represented by some other CA: • CA should advise client to disclose. • However he may continue to act for current year. **(May 1999)**	Where client was represented by him only: • CA should advise client to disclose. • If he refuses to disclose, CA should disassociate himself with client & then report tax authorities that accounts etc. previously reported by him are unreliable & thus he is disassociating himself with client. (But no disclosure of exact frauds done)	Which are being prepared: • CA should advise the client to disclose in A/c and returns. • If he refuses, disassociate himself with return and prepare audit report accordingly (qualified / adverse).	But CA's assignment is dispensed with before returns/audit report: • No further duty

Clause 2 – He certifies or submits in his/ his firm's name a report of an examination of financial statements unless examination is done by **(a)** him, **(b)** his partner, **(c)** his employee or **(d)** another CA in practice.

Thus he can render a report in his name only if work has been undertaken by him or under his supervision or by another CA i.e. Joint Auditor.

Clause 3 - He permits his/his firm's name to be used, in connection with an estimate of earnings contingent upon future transactions, in a manner which may lead to the belief that he vouches for the accuracy of forecast. **(May 2005, May 2008)**

Important Points:

i) As per SAE 3400 on prospective financial information, CA can participate in preparation of financial forecasts & their review. **(Nov 1998)**

ii) The Conditions for the above **(i)** are:

- CA should clearly indicate in his report:
  - **~** Source of information
  - **~** Basis of forecasts and
  - **~** Major assumptions. **(Nov 2009 Old)**
- Not vouch for accuracy of forecasts as forecasts can't be ascertained with accuracy

Clause 4 – He express his **opinion** on financial statements of any business or enterprise in which he, his firm or a partner in his firm or his **relative*** has a **substantial interest. (June 2009 New)**

***** As per Guidelines No. 1-CA (7)/02/2008 dated 8th August, 2008 and **relative** has same meaning as per Section 6 of the Companies Act, 1956.

Exception: If the appointment is meant for internal information system of valuation of cost of various products. **(Nov 2001)**

Important Points:

i) This clause is meant for **reports as well as certificates** which are to be submitted to any outside authority, but not where statements are prepared by members in employment for information systems of their employers etc.

ii)

If CA is employee of concern	He cannot audit financial statements of employer.
CA is part-time lecturer in a College	He/ his firm not to accept auditor-ship of college.
CA is appointed as liquidator	He cannot audit statements of Accounts.
A partner of CA is trustee of trust	CA/ his firm cannot audit FS of trust.
Writing books of A/cs of enterprise	He can't audit the FS of same enterprise.
CA is internal auditor of a concern	He can't accept statutory audit of same concern.

iii)

In Relation To			
Business Enterprise in Which		**Business Enterprise in Which**	
CA himself is owner / partner	CA himself is director	Partner/ relative of CA is a director	Partner/relative of CA has substantial interest
Can't audit	Can't audit	Can't audit	Can't audit **(May 2004)**

iv) The council has clarified that the members are not permitted to write books of their auditee clients.

Clause 5 - He fails to disclose a **material** fact** known to him which is not disclosed in **Financial Statement*** but disclosure of which is necessary in making such financial statements where he is concerned with that financial statement in professional capacity. **(May 2004, Nov 1997)**

***The word **Financial Statement** will cover both reports and certificates

Important Points:
i) Materiality should be judged in relation to both P/L & B/S. An item can be material from point of view of P/L A/c, may not be material from the point of view of B/S.

Some Of The Decisions Of Supreme Court/ High Court/Council
i) Where a CA failed to report to the shareholders of a company about the **non-creation of a sinking fund** in accordance with the Debenture Trust Deed (Davar & Sons Ltd. vs. M.S. Krishnaswamy)
ii) Where a CA failed to examine how debts become bad and were written off - Held he was guilty under Clause (5). (A. Doraiswamil Naidu-vs. P.M. Raghavendra Rao)
iii) Where a CA had **not disclosed** the fact that **loan have been given out of the funds of an Employees Provident Fund to the Employer Co**. in contravention of the Rules of the Provident Fund and had failed to report or the default in clearing the cheques received in re-payment of the loan. Supreme Court held guilty as it was his duty to have made a disclosure thereof to the beneficiaries of the Provident Fund in the statement of accounts signed by him. (Kishori Lal Dutta vs. - P.K. Mukherjee) **(June 2009)**
iv) If a CA is appointed to represent the company before the tax authority and certain information and explanations, which were later found to be **false and misleading,** is given to him **by management** to submit before tax authorities he is not guilty as he had only submitted them on the instruction of his client. **(Nov 2007)**

Clause 6 - He fails to **report a material misstatement** known to him to appear in a financial statement with which he is concerned a professional capacity. **(Nov 1995)**
E.g. - A C.A. didn't disclose an understatement of liability by company which results in suppression of current state of affairs.
A CA failed to disclose a misstatement or under statement by the company in the B/S of its liabilities, which amounted to a suppression of the correct state of affairs.

Clause 7 - He does not exercise **due diligence***, or is **grossly negligent**** in conduct of his professional duties. **(Nov 2003, May 1998)**
***Due Diligence** means careful and thorough work or effort. Mere non-performance or defective performance of a duty may be considered as failure to exercise "Due Diligence".
****Gross negligent** implies negligence of high degree, either arising out of recklessness or deliberate failure to act honestly and reasonably on a material matter.

Important Points:
i) If a CA is appointed to carry out a B/S audit and later an internal auditor detected certain irregularities at a branch level which is not detected by the auditor, he is not guilty as he is not required to check the matters relating to branch in depth. **(Nov 1997)**

ii) Few examples of gross negligence on the part of a member:
a. Where CA **gave clean reports** where as the reports on the Special Audit conducted **subsequently revealed irregularities** which amounted to failure to examine pass book and to verify cash balance.
b. A CA adopted **arbitrary valuation of closing stock** & no verification was done by him.
c. Failure to point out contravention of requirements of **schedule VI** of the Companies Act.
d. Failure to detect **fraud committed by accountant** which could have been detected if he had properly checked cash book.
e. A CA **relied upon IC without satisfying himself** about the propriety and surrendered to the pressure of management and certified the accounts without examining.
f. Where CA in practice have **signed two B/S** on two different dates for the same financial year, the first one with a clean report and the second one with a qualified report. Because

he later on issued a clean report and did not refer the fact of having previously issued a qualified report, in lieu of which a clean report was being issued. **(May 1999)**
g. Included order still under negotiation as sales to reflect better financial position **(Nov 1999)**
h. Cashier absconded with proceeds of sales, the auditor failed to discover it and an investigation afterwards indicated that he did not exercise proper skill & care. **(Nov 2003)**

Clause 8 – He fails to obtain **sufficient information** to warrant the expression of opinion or his **exceptions are sufficient material** to negate the expression of an opinion. **(May 2004)**

Important Points:
i) A CA should express his opinion about truth or fairness of statements of accounts only after obtaining required data and information. He has to determine extent to which information is required.
ii) In case of inadequacy of information or data he should clearly, express his disclaimer in no uncertain terms. For e.g. where a CA relying on the work of internal auditor qualified his report that books and vouchers had been examined by internal auditor, the qualification amounted to exception sufficiently material to negate expression of an opinion.

Some Of The Decisions Of Supreme Court/ High Court/Council
i) A CA without examination of stock register and other relevant matters issued a wrong consumption certificate on the basis of which license of higher value, for which the unit was not entitled, was issued by Controller of Imports & Exports. (T.S. Vaidyanatha Iyer)
ii) A CA has issued a clean **certification of circulation**, however, there were interpolation of entries in the books and the absence of documents to support the receipts of monies from the agent. Held the CA was guilty of misconduct under Clause (8). (Audit Bureau of Circulations Ltd. vs. S. Narayanan)
iii) A statutory auditor would be guilty under this clause, if he performed his work so recklessly as to give his report-without looking into the books of account of a company, on the basis of work of internal auditor whose opinion turned out to be false. (J.C. Chandhok)

Clause 9 – If he fails to invite attention to any material departure from generally accepted audit procedures applicable to the circumstances.

Important Points:
i) If he **fails to perform the audit** as per such procedures, his report should draw attention to the material departure from such procedures.
ii) Failure to perform certain **statutory functions and duties** is not excused merely by giving a qualification or reservation in auditor's report. On failure he should clearly indicate reasons for failure to perform audit as per generally accepted procedures and standards.

Clause 10 - Fails to keep moneys of his client or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a **"reasonable time"***.
Exception: Fees or Remuneration
***"reasonable time"**, would depend upon the circumstances of each case.

Important Points:
i) An **advance received** by a CA against services to be rendered does not fall under Clause (10) of Part I of the Second Schedule.
ii) Moneys received for expenses to be incurred, for example, payment of prescribed

statutory fees, purchase of stamp paper etc., which are intended to be spent within a reasonably short time need not be put in a separate bank account.
iii) Moneys received for expenses to be incurred which are not intended to be spent within reasonably short time as aforesaid should be put in a separate bank account immediately.
iv) Moneys received by a CA, in his capacity as trustee, executor liquidator, etc. must be put in a separate bank account immediately

Some Of The Decisions Of Supreme Court/ High Court/Council
i) A CA was found for having failed to account satisfactorily for the various amounts entrusted to him by "the client and for failure to keep them in a separate bank account. (N.S. Chenoy vs. K.V. Subba Rao)
ii) A CA was found guilty of not keeping the client's money, in a separate account and not using it for the purpose of which it was given. (Mr. R.S. Murgai Re: VS. (1) S.K. Gadh & V.K. Bajaj Decided case)

PART - II of THE SECOND SCHEDULE
"Professional misconduct in relation to members of the Institute generally"

Clause 1 - He Contravenes any of the provisions of this **act** or **regulations*** made there under, or any **guidelines** issued by the Council. **(May 1998, Nov 1998)**

***Few Regulations** which are generally contravened are as follows -

Regulation 43	Engagement of Articled Assistant
Regulation 46	Registration of Articled Assistant
Regulation 47	Premium from Articled Assistant
Regulation 48	Stipend to Articled Assistant
Regulation 56	Termination or assignment of Articles
Regulation 65	Articled Assistant not to engage in any other occupation
Regulation 67	Complaint against the employer (From Articled Assistant)
Regulation 68 to 80	Audit Assistant
Regulation 190	Register of offices and firms
Regulation 190A	CAs not to engage in any other Business or occupation
Regulation 191	Part time employments a CA may accept
Regulation 192	Restriction on fees

Some Important points regarding some C.A. regulations:
i) Monthly payment of **stipend** to every article. It must be confirmed beyond all doubts that payment has been made.
ii) It is duty of C.A. to forward **article deed** to ICAI.
iii) A C.A. **can't take loan** from any enterprise in which article is interested. However he may accept the same from any enterprise where in article's relative is interested. But it must not be taken as a consideration for admitting the article into firm.
iv) Now, no **premium** can be accepted by C.A from article.
v) Practice work should be performed only after obtaining **COP.**

Notifications
i) If he accepts more than **specific Tax audit assignment, which is 45.**
ii) If he accepts more than **specific Company audit assignment, which is 30.**
ii) A C.A. in practice has to **maintain proper Books** of Accounts including Cash Book / Ledger. **(Nov 1998)**
iii) A member who is an **employee** shall be deemed to be guilty if he is **willfully and grossly negligent** in conduct of his duty as employee. **(May 1998)**

iv) He **shouldn't be cost auditor** of company in which he is **(a)** auditor; **(b)** officer/employee; **(c)** partner, or in employment of officer/employee of company; **(d)** partner or in employment of company's auditor; **(e)** indebted/guarantor for an amount exceeding Rs. 1000.
v) He **can't become auditor** of company, while he's an employee of cost auditor of company.
vi) A CA in practice will be guilty of professional misconduct if he accepts auditor ship of a concern while he is **indebted** to the concern or has given any guarantee for limits fixed in the statute and in other cases exceeding Rs. 10,000.
vii) A CA in practice will be guilty of professional misconduct, if he **accepts statutory auditor ship of PSU/ listed** Co. / Govt. Co. or other Public Co. having turnover 50 crores or more in a year and accepts any other work or services with regard to same undertaking on a remuneration which in total exceeds the fees payable for carrying out the statutory audit of the same.
viii) A member in practice shall follow the **direction given, by the Council** or an appropriate Committee or on behalf of any of them, to him being the **incoming auditor**(s) **not to accept the appointment** as auditor(s), in the case of **unjustified removal** of the earlier auditor(s).
ix) A member of the Institute in practice shall not accept the appointment as auditor of an entity in case the **undisputed audit fee** of another CA for carrying out the **statutory audit** under the Companies Act, 1956 or various other statutes has not been paid except in case of **Sick Company.**
x) Minimum fees to be charged (p.a.) w.r.t. audit assignment:

	5-9 partner	>= **10 partner**
Large cities (population 3 million or above)	6000	12000
Small cities (population less than 3 million)	3500	8000

Exception:
a) Sales tax audit & VAT audit.
b) Certificate / Attestation / Report under the Income Tax Act.
c) Audit of newly concern (2 years from commencement of business).
d) Statutory audit of branches of banks including Regional rural banks (RRB).
e) Honorary appointments for charitable organizations or Club.

Some Of The Decisions Of Supreme Court/ High Court/Council
i) A CA contended that Regulation 48 did not prescribe the periodicity of payment but only the **rate** at which stipend should be paid. Contention was found to be in contravention of Regulation 48 as stipend should be paid on a **monthly basis**. (Case of B. B. Rohatgi)
ii) CA received Rs. 2000 by way of **security** from the complainant's father for taking him as an articled clerk. Held he was guilty under the provisions. (Virender Kumar vs. K. B. Madan)
iii) Where a C.A. had an agreement to **pay his articled clerk on annual basis**, it was held that there was violation of provisions of Regulation 48. (Case of Radhey Mohan)
iv) A CA certified that an **audit clerk was in service** with him, while he was also employed elsewhere form 11 A.M. to 5 P.M. and attended the C.A.'s office thereafter until 8 P.M. Held that, the CA. was guilty of making **misstatement** to the Institute. (Case of J. K. Ghosh)
v) A CA took **loan from a firm** in which the Articled Clerk and his father were both interested, against the provisions of CAs Regulations, 1988 which prohibit taking a loan or deposit etc. from a articled clerk. Held the CA was guilty of professional misconduct under this clause. (Case of M. K. Tripathi)

Clause 2 - He being an employee of a company / firm / person, discloses confidential information acquired in the course of his employment.

Exception:
i) As and when required by the Law or
ii) As permitted by the employer

Clause 3 - He includes in any information/statement/return/form to be submitted to ICAI, Council, any Committee, Disciplinary Directorate, Board of Discipline, Disciplinary Committee, Quality Review Board, Appellate Authority particulars knowing them to be false.
Example:
1. Article clerk was attending college & coaching class during training hours. But C.A. confirmed to council that article was regular in office knowing that he is delivering wrong statement. Thus guilty.
2. During hearing before disciplinary committee, a CA gave untrue statement knowingly.
3. While applying for renewal of cop, a C.A. supplied wrong statement that he is not engaged in other occupation while he was. Thus guilty.

Clause 4 - He -
i) Defalcates or embezzles money
ii) Received in his professional capacity

PART - III of THE SECOND SCHEDULE
"Other misconduct In relation to members of the Institute generally"

A member of the Institute, whether in practice or not shall be deemed to be guilty of other misconduct, If he is held guilty by any **civil or criminal Court for an offence** which is punishable with imprisonment for a term **exceeding 6 months**.

Statement On Continuing Professional Education (CPE) - All members of the Institute, except those who are exempted below, are required to meet the CPE credit requirement as would be recommended by the Council from time to time.
Exception:
i) A member who attains the age of 60 years during a particular calendar year;
ii) A member, for the year during which he gets his membership for the first time;
iii) A member or class of members to whom the CPE Committee grant Full/Partial exemption.
Penal action, as would be decided by the Council, will be taken on the members who have shown their **willful non-compliance**, with the requirements of this Statement.

1.8 Disciplinary Procedure - Amended provisions of the CA, Act, 1949 read with The CAs (Procedure of Investigations of Professional and Other Misconduct of Cases) Rules, 2007 regarding investigation of misconduct by members has been summarized as under:
i) Disciplinary Directorate,
ii) Board of Discipline,
iii) Disciplinary Committee,
iv) Appellate Authority and procedure in enquiries for disciplinary matters relating to misconduct of members of ICAI as per amendment No. 9 of 2006 assented by the President of India on 22nd March 2006 & published in Gazette of India on 23rd March 2006 are:

i) Section 21: Disciplinary Directorate -
a. The Council shall, by notification, establish a Disciplinary Directorate headed by an officer of the Institute designated as Director (Discipline) and such other employees for making investigations in respect of any information or complaint received by it.
b. On receipt of any information or complaint along with the prescribed fee, the Director (Discipline) shall arrive at a prima fade option on the occurrence of the alleged misconduct.

c. Where the Director (Discipline) is of the opinion that a member is guilty of any professional or other misconduct mentioned in the First Schedule, he shall place the matter before the Board of Discipline and where the Director (Discipline) is of the opinion that a member is guilty of any professional or other misconduct mentioned in the Second Schedule or in both the Schedules, he shall place the matter before the Disciplinary Committee.
d. In order to make investigations under the provisions of this Act, the Disciplinary Directorate shall follow such procedure as may be specified.
e. Where a complainant withdraws the complaint, the Director (Discipline) shall place such withdrawal before the Board of Discipline or, as the case may be, the Disciplinary Committee, and the said Board of Committee may, if it is of the view that the circumstances so warrant, permit the withdrawal at any stage.

ii) Section 21 A: Board of Discipline -
a. The Council shall constitute a Board of Discipline consisting of -
• A person with experience in law and having knowledge of disciplinary matters and the profession, to be its presiding officer,
• Two members one of whom shall be a member of the Council elected by Council & other member shall be nominated by CG from amongst the persons of eminence having experience in the field of law, economics, business, finance or accountancy;
• The Director (Discipline) shall function as the Secretary of the Board.
b. The Board of Discipline shall follow summary disposal procedure in dealing with all cases.
c. Where the Board of Discipline is of the opinion that a member is guilty of a professional or other misconduct mentioned in the First Schedule, it shall afford to the member an opportunity of being heard before making any order against him and may thereafter take any one or more of the following actions, namely:
• Reprimand the member;
• Remove the name of the member from the Register up to a period of three months;
• Impose such fine as it may think fit, which may extend to rupees one lakh.
d. The Director (Discipline) shall submit before the Board of Discipline all information and complaints where he is of the opinion that there is no prima facie case and the Board of Discipline may, if it agrees with opinion of the Director (Discipline), close the matter or in case of disagreement, may advise the Director (Discipline) to further investigate the matter.

iii) Section 21 B: Disciplinary Committee -
a. The Council shall constitute a Disciplinary Committee consisting of the President or the Vice- President of the Council as the Presiding Officer and two members to be elected from amongst the members of the Council and two members to be nominated by the CG from amongst the persons of eminence having experience in the field of law, economics, business, finance or accountancy. Provided that the Council may constitute more Disciplinary Committees as and when it considers necessary.
b. The allowances payable to members nominated by CG shall be such as may be specified.
c. Where the Disciplinary Committee is of the opinion that a member is guilty of a professional or other misconduct mentioned in the Second Schedule or both the First Schedule and the Second Schedule, it shall afford to the member an opportunity of being heard before making any order against him and may take any one or more of the following actions, namely:
• reprimand the member;
• remove name of member from Register permanently or for such period, as it thinks fit;
• Impose such fine as it may think fit, which may extend to Rs. **five lakh**.
d. The allowances payable to members nominated by CG shall be such as may be specified.

iv) Section 21 C - Authority, Disciplinary Committee, Board of Discipline and Director (Discipline) to have powers of civil court - For the purposes of an inquiry under the provisions of this Act, the Authority, the Disciplinary committee, Board of Discipline and the Director (Discipline) shall have the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908), in respect of the following matters, namely:
a. Summoning and enforcing the attendance of any person and examining him on oath;
b. The discovery and production of any document; and
c. Receiving evidence on affidavit.
Explanation: for the purposes of section 21, 21A, 21B, 21C and 22, "member of the Institute" includes a person who was a member of ICAI on the date of the alleged misconduct although he has ceased to be a member of ICAI at the time of the inquiry.

v) Section 22 A: Constitution of Appellate Authority -
a. The CG shall, by notification, constitute an Appellate Authority consisting of -
• a person who is or has been a judge of a High Court, to be its Chairperson;
• two members to be appointed from amongst the persons who have been members of the Council for at least one full term and who is not a sitting member of the Council;
• two members to be nominated by the CG from amongst persons having knowledge and practical experience in the field of law, economics, business, finance or accountancy.
b. The Chairperson and other members shall be part-time members.

vi) Section 22 B: Term of office of Chairperson and members of Authority -
a. Person appointed Chairperson shall hold office for a term of three yrs from the date on which he enters his office or until he attains the age of sixty-five years, whichever is earlier.
b. Person appointed as member shall hold office for a term of three yrs from the date on which he enters his office or until he attains the age of sixty-two years, whichever is earlier.

vii) Section 22 C: Allowances and conditions of service of Chairperson and members of Authority – The allowances payable to, and other terms and conditions of service of, the Chairperson and members are the manner of meeting expenditure of the Authority by the Council and such other authorities shall be such as may be specified.

viii) Section 22 D: Procedure to be regulated by Authority -
a. The office of the Authority shall be at Delhi.
b. The Authority shall regulate its own procedure.
c. All orders and decisions of the Authority shall be authenticated by an officer duly authorized by the Chairperson in this behalf.

ix) Section 22 E: Officers and other staff of Authority -
a. The Council shall make available to the Authority such officers and other staff members as may be necessary for the efficient performance of the functions of the Authority.
b. The salaries and allowances and conditions of service of the officers and other staff members of the Authority shall be such as may be prescribed.

x) Section 22 F: Resignation and removal of Chairperson and members -
a. The Chairperson or a member may, by notice in writing under his hand addressed to the CG, resign his office. Provide that the Chairperson or a member shall, unless he is permitted by the CG to relinquish his office sooner, continue to hold office until the expiry of three months from the date of receipt of such notice or until a person duly appointed as his successor enters upon his office or until the expiry of term of office, whichever is earlier.
b. The Chairperson or a member shall not be removed from his office except by an order of the CG on the ground of proved misbehavior or incapacity after an inquiry made by such

person as the CG may appoint for this purpose in which the Chairperson or a member concerned has been informed of the charges against him and given a reasonable opportunity of being heard in respect of such charges.

xi) Section 22 G: Appeal to Authority -

a. Any member of ICAI aggrieved by any order of The Board of Discipline or the Disciplinary Committee imposing on him any of the penalties referred to in sub-section (3) of section 21 A and sub-section (3) of section 21 B, may within ninety days of the date on which the order is communicated to him, prefer an appeal to the Authority. Provided that the Director (Discipline) may also appeal against the decision of Board of Discipline or the Disciplinary Committee to the Authority, if so authorized by the Council, within ninety days; Provided further that Authority may entertain any such appeal after expiry of said period of ninety days, if it is satisfied that there was sufficient cause for not filling the appeal in time.

b. The Authority may, after calling for the records of any case, revise any order made by the Board of Discipline or the Disciplinary committee under sub-section (3) of section 21 A and sub-section (3) of section 21 B and may -

- Confirm, modify or set aside the order;
- Impose any penalty or set aside, reduce, or enhance the penalty imposed by the order;
- Remit the case to the Board of Discipline or Disciplinary Committee for such further enquiry as the Authority considers proper in the circumstances of the case; or
- Pass such other order as the Authority thinks fit:

Provided that the Authority shall give an opportunity of being heard to the parties concerned before passing any order."

FLOW CHART OF DISCIPLINE PROCEDURE MECHANISM

Complaint against member of ICAI of alleges misconduct along with prescribed fee.

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Disciplinary Directorate

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The Director (Discipline) shall arrive at a prima facie opinion on the occurrence of alleged misconduct and decide whether he is guilty of professional or other misconduct falling in

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First Schedule	**Second schedule or Both Schedules**
Place the matter before	Place the matter before
↓	↓
Board of Discipline	**Disciplinary Committee**
If found guilty, it can • reprimand the member • Remove the name of member up to a period of 3 months • impose fine up to Rs. 1, 00,000	If found guilty, it can • reprimand the member • Remove the name of member permanently or for any period • impose fine up to Rs. 5, 00,000

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Any member aggrieved by order of Board of Disciplinary Committee can prefer an appeal within 90 days before **Appellate Authority**

It Can
- Confirm, modify or set aside the order,
- Impose, Set aside, Reduce or enhance penalty
- Remit the case to the Board of Discipline or Disciplinary Committee for reconsideration
- Pass such order as the Authority thinks fit.

CASE STUDIES

Q1. Mr. A, a practicing CA agreed to select and recruit personnel, conduct training programmes for and on behalf of a client. (Nov. 98 & Nov. 2007)
Hint Ans: Not guilty as the expression "Management Consultancy and other Services" includes Personnel recruitment and selection.

Q2. P, a CA in practice provides management consultancy and other services to his clients. During 2005, looking to the growing needs of his clients to invest in the stock markets, he also advised them on Portfolio Management Services whereby he managed portfolios of some of his clients. (May 2006)
Hint Ans: It is specifically stated by the council of ICAI that CAs in practice are not permitted to undertake the activities of broking, underwriting and portfolio management Services. Thus, a CA in practice is not permitted to manage portfolios of his clients.

Q3. G & Co., a firm of CAs, was appointed as the internal auditor of Easy Ltd., replacing H & Co., another firm of CAs, which had expressed their inability to continue as internal auditor to the management through a resignation letter. G & Co. proceeded to conduct the internal audit without communicating with H & Co.
Hint Ans: Guilty; As he accepts a position as an auditor previously held by another CA or a certified auditor without first communicating with him in writing.

Q4. Mr. I, a CA, had an account with a bank. The normal balance in this account remained at a level below Rs. 25,000. The bank inadvertently credited this account with a cheque of Rs. 2, 50,000 belonging to another account holder. When Mr. I came to know about this he withdrew the amount of Rs. 2, 75,000 and closed the bank account. After 1 year the bank noticed the mistake and claimed Rs. 2, 75,000 with interest. Mr. I contested this claim. Can the bank approach the ICAI for disciplinary action against Mr. I?
Hint Ans: Guilty; as he brings disrepute to the profession or the Institute as a result of his action whether or not related to his professional work.

Q5. A CA firm pays share in profits to widow of its deceased partner. (June 2009)
Hint Ans: If such a clause is present in partnership deed, sharing is permissible, otherwise not. If no such clause exists, and if the firm still pays share in the profits to a widow of the deceased partner, the firm shall be considered as guilty of professional misconduct.

Q6. Mr. Sethi a CA in practice, who is proposed to be removed as auditor of a co, makes unsubstantiated and derogatory remarks against the management of the company in his representation u/s 225 of the Companies Act, 1956. (May 1997)
Hint Ans: Guilty as Unsubstantiated and derogatory remarks against the management of the company by Mr. Sethi, a CA in practice, on his proposed removal as an auditor of a company is not the behavior of a professional CA.

Q7. Ashok Mittal is the auditor of partnership firm consisting of Ram and Shyam as partners. In his audit report to the firm, he did not refer certain materially irregular transactions found in the books of the firm for the reason that Ram, the senior partner approved all such transactions.

Hint Ans: In case of partnership firm partners are jointly and individually liable hence Ram and Shyam both are Guilty as he fails to disclose a material fact known to him which is not disclosed in the FS or fails to report on a material misstatement known to him to appear in a FS with which he is concerned in a professional capacity.

Q8. Mr. Z, practicing CA has written to a Director of Technical Education requesting him for allotment of audit of certain schools (MAY 91)
Hint Ans: Guilty as a member in practice is not allowed soliciting clients for professional work either directly or indirectly by any other means. However, if he follows advertisement guidelines, he will not be guilty.

Q9. Mr. S, a CA published a book and gave his personal details as the author. These details also mentioned his professional experience and his present association as partner with M/s. RST, a firm. (Nov. 2005)
Hint Ans: Guilty as a member is not permitted to indicate in a book or an article, published by him, the association with ay firm of CAs. Mr. S being a CA in practice has committed misconduct by mentioning that he is a partner in M/s. RST, a CA firm. However, if he follows advertisement guidelines, he will not be guilty.

Q10. M/S. LMN, a firm of CA responded to a tender from a SG for computerization of land revenue records. For this purpose, the firm also paid Rs. 50,000 as earnest deposit as part of the terms of the tender. (May 2006)
Hint Ans: Not guilty because as per the guidelines if a matter relates to any services other than audit, members can respond to any tender.

Q11. A partner of a firm of CA during a T.V. interview handed over a Bio-data of his firm to the Chairperson. Such bio-data detailed the standing of the international firm with which the firm was associated; it also detailed the achievements of the concerned partner and his recognition as an expert in the field of taxation in the country. The chairperson read out the bio-data during the interview. What is your opinion on the given case? (Nov. 2001)
Hint Ans: Guilty because such an act would definitely lead to the promotion of the firm's name and publicity thereof as well as of the partner and as such the handing over of bio-data cannot be approved. However, if he follows advertisement guidelines, he will not be guilty.

Q12. CA Vijay who conducted ABC audit of a Marathi daily 'New Era' certified the circulation figures based on M.I.S Report without examining the books of Account.
Hint Ans: Guilty; as he did not exercise due diligence & is grossly negligent in the conduct of his professional duties since he certified circulation figures without examining books of A/cs.
Q13. M/s. XYZ, a firm in practice, develops a website "XYZ.com". The color chosen for the website was a very bright green and the web-site was to run on a "push" technology where the names of the partners of the firm and the major clients were to be displayed on the web-site. Discuss the case with reference to the CA Act, 1949.
Hint Ans:
Not Guilty - Colour, Names of Partner;
Guilty - Website on Push Mode, Names of Clients.

Q14. M/s XYZ, a firm of CA created a website www.xyzindia.com. The website besides containing details of the firm and bio-data of the partners also contains the photographs of all the partners of the firms. (MAY 2005)
Hint Ans: Not Guilty as the guidelines of the ICAI allow a firm to put up the details of the firm, bio-data of partners and display of a passport size photograph.

Q15. XYZ & Associates, a CA firm developed a website www.xyzassociates.com. The website also contained a link to "All India CAs Association", a voluntary association where X, a partner of the firm is currently the Vice-president. (May 2006)
Hint Ans: Guilty because it is permitted that website may provide a link to the website of ICAI, its Regional Councils, Branches and Government Departments and other professional Bodies like AICPA, ICAEW, CICA. In this case, M/s. XYZ Associates provided a link to "AICAA" which is not permitted.

Q16. A CA in practice created his own website in attractive format and colors and circulated the information contained in the website through E-mail. (May 2007)
Hint Ans: Guilty as none of the information contained in the website be circulated on their own or through E-mail or by any other mode except on a specific "Pull" request.

Q17. A practicing CA uses a visiting card in which he designates himself besides as CA, as
a. Tax Consultant
b. Cost Accountant (Nov. 2000)
Hint Ans:
a. Tax Consultant: Guilty because use of any designation or expression other than CA for a CA in practice, on professional documents, visiting cards, etc. amounts to a misconduct unless it be a degree of a university or a title indicating membership of any other professional body recognized by the CG.
b. Cost Accountant: Guilty as a CA in practice cannot use any other designation than that of a CA. Nevertheless, a member in practice may use any other letters or descriptions indicating membership of accountancy bodies approved by the Council.

Q18. H, a CA in practice is a partner in 3 firms. 'On the personal Letter Heads of H, names & address of all the 3 firms are mentioned. (June 09 New)
Hint Ans: Not Guilty as there is no prohibition for printing names of all 3 firms on the personal letter heads in which a member holding certificate of practice is a partner.

Q19. 'While taking Mr. Q as his articled clerk, Mr. R, a practicing CA proposed that the stipend as per regulations will be paid once a year calculated on the monthly rates prescribed by ICAI to which Mr. Q also agreed.
Hint Ans: Guilty because of nonpayment of stipend on monthly basis even though his article clerk also agreed to his proposal. Is this amounts to contravention of the provisions of the CA (Amendment) Act 2006 or the regulation; made there under or any guidelines issued by the Council.

Q20. W, a CA has sent letters under, certificate of posting to the previous auditor informing him his appointment as an auditor before the commencement of audit by him. (Nov 2003)
Hint Ans: Guilty because mere posting of a letter "under certificate of posting" is not sufficient to prove communication with the retiring auditor. There should be some evidence to show that the letter has in fact reached the person communicated with.

Q21. BC & Co, a firm of CAs, accepted an assignment for audit under State level VAT Act, without any prior communication with the previous auditor. (May 2008)
Hint Ans: Guilty as he accepted a position as auditor previously held by another CA without first communicating with him in writing.

Q22. P, a CA had accepted appointment as an auditor of QRS Company Ltd without ascertaining from the Company whether the requirement of Sections 224 and 225 of the Companies Act had been complied with. However, he realized this defect only after

acceptance. (Nov 2003)
Hint Ans: Guilty as a CA, before acceptance of his appointment as an auditor has failed to ascertain whether the provisions of Sections 224 and 225 have been complied with by Co.

Q23. Mr. Jaydev has charged a fee for representing his client in an Income Tax appeal based on expected relief to his client as a result of the appeal. Is there any professional misconduct In this case? (Nov1996)
Hint Ans: Guilty; A CA in practice who charges or accepts in respect of any professional employment fees which are based on a % of profits except in cases which are permitted under any regulation made under the C.A. Act

Q24. The chairman of an Audit Committee of a Blue Chip Company, who is a CA, asked the firm in which he was previously a partner to quote their fee on success fee basis so as to ensure that a professional work is assigned to such firm. Do you approve the chairman's contention? (Nov. 2001)
Hint Ans: Guilty as the remuneration based on a percentage of the profits or on the happening of a particular contingency is prohibited.

Q25. Mr. J started his practice as CA in 1996, he got an offer for the post of Chief Accountant of a Software Development Co, as a fulltime employee, for a salary of Rs. 60,000 per month. On accepting this offer, Mr. J converted his practice into a partnership firm by taking a fresh CA as his partner. Neither Mr. J neither intimated the Institute nor obtained permission from the institute about his employment. Will Mr. J be held guilty under the CA Act? (May 2003)
Hint Ans: Guilty since he has accepted the full time salaried employment in addition to the practice of Chartered Accountancy without obtaining permission of the Institute.

Q26. A CA holding certificate of practice and having four articled clerks registered under him accepts appointment as full-time lecturer in a college. Also he becomes a partner with his brother in a business. Examine his conduct in the light of CA Act, 1949 and the regulations there under. (MAY. 2000)
Hint Ans: A member can accept full-time lectureship in a college only after obtaining the specific and prior approval of the Council. As also becoming a partner in a business with his brother would require specific permission of the Council. He is Guilty as he failed to obtain specific and prior approval of the Council in each case.

Q27. A CA in practice has been suspended from practice for a period of 6 months and he had surrendered his COP for the said period. During the said period of suspension, though the member did not undertake any audit assignments, he undertook representation assignments for income tax whereby he would appear before the tax authorities in his capacity as a CA. (Nov. 2002)
Hint Ans: A CA would not be allowed to represent before the income tax authorities for the period he remains suspended.

Q28. M, a CA in practice, is the Statutory Auditor of S Ltd. for the year ended 31st March 2008. In January 2008, he was appointed as a Director in H Ltd., which is the holding Company of S Ltd. (May 2008)
Hint Ans: An auditor of a subsidiary cannot be a director of a holding company as it will affect his independence.

Q29. Mr. R, a CA in practice has been elected as the treasurer of a Regional Council of the Institute. The Regional Council had organized an international tour through a tour operator during the year for its members. During the audit for the Regional Council, It was found that

Mr. R had received a personal benefit of Rs. 50,000/- from the tour (Nov. 2002)
Hint Ans: Guilty because a CA is expected to maintain highest standards of integrity even in his personal affairs and any deviation from these standards even in his non professional work would expose him to disciplinary action. Mr. R would be liable for disciplinary action.

Q30. At the AGM in a Public Ltd Co. held on April 1, 1966, M/s Bat & Ball a CA firm was appointed to audit accounts of the Co. for the calendar year 1996. However, the next AGM of the Company did not take place until January 1999. M/s Bat and Ball insist that they alone are entitled to audit the accounts not only for the year, 1996 but also for the years 1997 and 1998 respectively. (MAY 99)
Hint Ans: The tenure of an auditor is from the conclusion of one AGM to the conclusion of the next AGM. The CLB held that the auditor's appointment is not related to the accounts of a particular FY. The auditor appointed for the year 1996 could audit the accounts for the year 1997 and 1998 during which no AGM was held.

Q31. A is the auditor of Z Ltd., which has a turnover of Rs. 200 crore. The audit fee for the year is fixed at Rs. 50 lakhs. During the year, the company offers an assignment of management consultancy within the meaning of Section 2(2)(iv) of the CA Act, 1949 for a remuneration of Rs. 1 crore. A seeks your advice on accepting the assignment. (May 2007)
Hint Ans: He will be deemed to be Guilty if he accepts the appointment as a statutory auditor on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same undertaking.

Q32. S, a practicing CA gives power of attorney to an employee CA to sign reports and FS, on his behalf. (May 2007)
Hint Ans: Guilty because he allowed any person not being his partner to sign on his behalf any B/S, P&L A/C and report on FS.

Q33. A CA in practice, in spite of requests from the secretary of the Institute, fails to submit form No.18. Is he liable for the misconduct? (May 2001)
Hint Ans: Guilty as a member is required to supply the information called for by the Council. Thus, failure to submit form 18 constitutes professional misconduct.

Q34. XY & Co., a firm of CA having 2 partners X & Y, one in charge of Head Office and another in charge of Branch at a distance of 80 kms, puts up a name board of the firm in both premises and also in their respective residences. (Nov. 2007)
Hint Ans: Guilty **–** As there is restriction on putting up of name of CA firm on a name plate at residence.

Q35. As auditor of a Chemical Industry, Abhaya becomes aware of the secret production process of the company developed at an enormous cost. She describes the same in detail to her brother little aware that he will take advantage of this information to start a similar industry on his own.
Hint Ans: Guilty as she disclosed information acquired in the course of his professional engagement to any person other than his client, without the consent of his client or otherwise.

Q36. XYZ Co. Ltd has applied to a bank for loan facilities; the bank on studying the FS of the Co. notice that you are the auditor and request you to call at the bank for a discussion. In the course of discussions, bank asks for your opinion regarding the company and also asks for detailed information regarding few items in the FS. The information is available in your working paper file. What should be your response and why? (May 2000)
Hint Ans: The auditor cannot disclose the information in his possession without specific

permission of the client. Thus, there is no requirement compelling the auditor to divulge information obtained in the course of audit and included in the working papers to any outside agency except as and when required by any law.

Q37. X, a CA availed a loan against his shares held as investments from a nationalized bank. He issued 2 cheques towards repayment of the said loan. Both the cheques were returned back by the bank with the remarks "Refer to Drawer". (May 2008)
Hint Ans: Guilty as the cheque was dishonored with the remark "refer to drawer" due to insufficiency of funds. A member is liable to disciplinary action if he is found guilty of any professional or "Other Misconduct".

Q38. A CA in practice was engaged by a businessman to represent him before the tax authorities on current matters and In the course of such employment he came across certain documents pointing to commission of tax frauds in the preceding years for which the client was not represented by him. (May 99)
Hint Ans: The member may continue to act for the client in respect of current matters, but is under no obligation so to continue. It is assumed that the past fraud does not affect in any way the current tax matters and the member should be extra careful to ensure that the past behavior is not reflected in current matters.

Q39. Z a CA certifies a financial forecast of his client which was forwarded to the client's bank based on which the bank sanctioned a loan to the client. (May 2005)
Hint Ans: Guilty as it appears that he has certified the financial forecast without taking adequate safe guards.

Q40. D, who conducts the tax audit u/s 44AB of the Income Tax Act, 1961 of M/s ABC, a partnership firm, has received the entire audit fees of Rs. 25,000 in April, 2009 in respect of the tax audit for the year ended 31.03.2009. The audit report was, however, signed on 25.05.2009. (June 09 New)
Hint Ans: Not Guilty as the provision of indebtness for more than Rs. 1,000/- applies to auditor appointed under companies act. No such similar provisions in the Income Tax Act.

Q41. A CA firm was appointed by a company to evaluate the costs of the various products manufactured by it for their Information system. One of the partners of CA firm was a non-executive director of the company. (Nov. 2001)
Hint Ans: The Council has stated that in case where a member is a Director of a company, the firm in which the said member is a partner, should not express any opinion on its FS. Since the firm has been appointed to evaluate costs of the various products manufactured by it for their information system, it cannot be construed to be misconduct. It is a verification of facts and no opinion is expressed.

Q42. Mr. Shah, a CA certified the FS of a company in which his wife is a Director holding substantial interest.
Hint Ans: Guilty as Mr. Shah has certified the FS of a company in which his wife is a director with Substantial Interest.

Q43. M/s LMN, a CA firm having 5 partners accepts an audit assignment of a newly formed private limited company for audit fees of Rs. 5,000. (June 09 New)
Hint Ans: M/s LMN can conduct the audit without violation because as per the provisions laid down in council guidelines the restriction does not apply for audit of newly formed concerns for 2 accounting years.

Q44. Mr. Joe, a CA during the course of audit of M/s. XYZ Ltd. came to know that the company has taken a loan of Rs. 10 Lakhs from Employees Provident Fund. The said loan was not reflected in the books of account. However, the auditor ignored this information in this report.
Hint Ans: Guilty as he failed to disclose a material fact known to him, which is not disclosed in the FS but disclosure of which is necessary to make the FS not misleading.

Q45. Miss Lata, a practicing CA, accepts her appointment as a Valuer of goodwill of a business for the purpose of determining the value of gift under the Gift Tax Act on the condition that she would be paid 5% of the value of the goodwill so determined as her fees.
Hint Ans: Not guilty. Gift tax is a direct tax. Thus she can charge a % of goodwill while acting in capacity of Valuer.

Q46. A practicing CA was appointed to represent a company before the tax authorities. He submitted on behalf of his clients certain Information and explanations to the authorities, which were found to be false and misleading. (Nov. 2007)
Hint Ans: Not Guilty as these statements are based on the data provided by management of the company. Although the statements prepared were based on incorrect facts and misleading, the CA had only submitted them acting on the instructions of his client as his authorized representative.

Q47. Mr. X partner of X & Co., CAs, has compiled and signed the B/S of false Ltd., for submission to the bankers of the said company. Mr. X has also complied and signed at the request of the company another B/S inflating the value of assets by 20% for submission to a term lending institution. Both the B/S was not in conformity with the books of account maintained by co. as they were not up-to-date. Comment on Mr. X's liability. (Nov 1999)
Hint Ans: Guilty as Mr. X had compiled two different B/Ss for the same period without reference to the actual books of accounts but on instructions of the client. Also he has failed to disclose material fact known to him.

Q48. CA Zeni who is a leading IT Practitioner and consultant in Mumbai is also trading in derivatives.
Hint Ans: Guilty; as he is engaged in any business or occupation other than the profession of CA without specific permission by the Council to engage.

Q49. The Cashier of a company committed a fraud and absconded with proceeds thereof. This happened during the course of the accounting year. The Chief Accountant of the company also did not know about fraud. In the course of the audit, at the end of the year, the auditor failed to discover the fraud. After the audit was completed, however, the fraud was discovered by the Chief Accountant. Investigation made at that time indicates that the auditor did not exercise proper skill and care and performed his work in a desultory and haphazard manner. With this background, the Directors of the company intend to file disciplinary proceedings against the auditor. (Nov 2003)
Hint Ans: It is the duty of an auditor to bring to bear in the work he has to perform that skill, care and caution as per the circumstances in an honest and reasonable manner. The auditor has been grossly negligent in performing his duties which constitutes misconduct.

Q50. A CA in practice was alleged to have signed two B/Ss on two different dates for the same FY, the first one with a clean report and the second one with a qualified report. In a criminal proceeding he made a statement before the magistrate that he had signed only the second B/S. (MAY 99)
Hint Ans: Guilty as he signed two B/Ss on the two different dates for the same FY and

makes a false statement before the magistrate regarding the first issue. He failed to discharge his duties in an honest and reasonable manner.

Q51. Mr. B, a practicing CA, expressed his opinion on FS of M/s ABC Ltd. for the year ended on 31st March, 2009. It was later found that the closing stock was valued arbitrarily by Management which was accepted by him without verification and large amount of revenue expenditure was capitalized. (June 2009)
Hint Ans: Guilty as he is grossly negligent in the conduct of his professional duties. Mr. B. adopted arbitrary valuation of closing stock and accepted the valuation as done by the management without verification. He also failed to point out large amount of revenue expenditure, capitalized, thereby affecting the profitability of the company.

Q52. Mr. G. a CA in practice as a sole proprietor has an office in Kolkata near Dumdum. Due to increase in professional work, he opens another office in a suburb of Kolkata which is approximately 80 kilometers away from his existing office. For running the new office he employs three retired I.T.O. [May, 2000]
Hint Ans: The distance of 2nd office from municipal limits of Kolkata is missing. Assuming it is more than 50 kms. Mr. G is a guilty because for such office, separate CA would be needed (Not retired I.T.O)

Q53. A charitable institution entrusted Rs. 10 lakhs with its auditors M/s. Ram & Co., a CA firm, to invest in a profitable portfolio. The auditors pending investment of money deposited it in their Savings bank account and no investment was made in the next 3 months.
Hint Ans: Guilty as he failed to keep money of his clients in a separate bank account or failed to use such money for purposes for which they were intended.

Q54. CA Dev, a CA prepared a project report for one of his clients to obtain bank finance (long-term) of Rs. 50 lakhs from a Commercial Bank. Consequent to the sanction of the loan by the bank CA Dev raised a bill for his services @ 2% of the loan sanctioned.
Hint Ans: Guilty; as the act prohibits a CA in practice to charge, to offer, to accept or accept fees which are based on a %age of profits or which are contingent upon the findings or results of such work done by him.

Q55. CA Ravi was appointed as the Auditor of XYZ Ltd. for 2010-11. Since he declined to accept the appointment, the BOD appointed CA Shree as the auditor in the place of CA Ravi, which was also accepted by CA Shree.
Hint Ans: Guilty; since the appointment of auditor can be made only by the CG and the Board appointment is defective in law. He accepted the appointment without first ascertaining whether the requirements of section 225 of the Companies Act, 1956 have been fully complied with".

Q56. Mr. Brilliant, a practicing CA, received a major professional assignment. To complete the said assignment he was required to buy four computers. Due to his Inability to provide funds for acquiring the same he borrowed money from a firm, where one of the Articled Clerk's and his father were interested. What will be the CAs liability? (Nov. 1997)
Hint Ans: Accepting a loan from an articled clerk in case of an engagement of an article clerk is prohibited under the Regulations. Thus, Mr. Brilliant will be held guilty. As it appears from the facts of the case, the articled clerk is already been engaged and serving his article and thus, normally, Mr. Brilliant will not held Guilty.

Q57. A, CA In practice, who was entitled to take not more than five articled clerks had already taken five such clerks, represented to X that he had still a vacancy and induced him to enter into articles with him. A formal deed was executed. A subsequently cancelled the

articles of fifth articled clerk for irregular attendance without reference to the institute. Explain whether A can be deemed guilty of professional misconduct. (May 90)
Hint Ans: Guilty because the CA had misrepresented to a person, that he had a vacancy and induced him to enter into articles. Further, he cancelled the articles for irregular attendance without reference to the Institute.

Q58. AB & Co, a CA firm included the name of 'P' as a partner while filing an application for empanelment as auditor for Public Sector bank branches. It was subsequently noticed that on the date of application, P was not a partner with AB & Co. (Nov. 2007)
Hint Ans: Guilty as AB & Co., included another CA's name as partner in his firm, in his application for empanelment as Auditor of branches of Public Sector Banks submitted to the Institute & In fact such a member was not a partner of the said firm on the date of application.

Q59. Mr. K a CA not in practice was employed by Do-well Ltd. on Salaried basis as Chief Internal Auditor to be in charge of IC and internal audit department of the Company. Mr. K largely relied on the work of other unqualified employees of the Company. The Statutory Auditor subsequently found that the IC was weak, that there were omissions to record Cash Sales and collections from Debtors and the statements attested by the Chief Internal Auditor were all either untrue or false. The company seeks your advice whether any action could be taken against Mr. K under provisions of CAs Act. (May 1998)
Hint Ans: Guilty as it appears that the internal auditor had merely relied on the work of his unqualified assistants and failed to exercise reasonable care and skill and thus was grossly negligent in the performance of his duties.

Q60. Mr. Careless is a partner in a CA firm which did not maintain books of account in respect of professional Income & expenditure. Is there any misconduct?
Hint Ans: Guilty because he or his CA firm in which he is partner failed to maintain in respect of his professional practice, proper books of accounts including cash book and ledger at the place where the profession is carried out.

Q61. Q, a CA, failed to report to the shareholders of the Z Ltd, about the non-creation of a sinking fund in accordance with the Debenture Trust Deed and did not make clear that the amount shown as Sinking Funds, were borrowed from the Managing Agents of the Z Ltd.
Hint Ans: Guilty; he fails to disclose a material fact known to him which is not disclosed in the FS, but disclosure of which is necessary in making such FS in a professional capacity.

Q62. M/s Suraj & Company are the Cost Auditors of Beauty Cosmetics Ltd. duly appointed u/s 233 B of the Companies Act, 1956. Mr. Kiran, a CA, holding a certificate of practice who is a part time employee of M/s Suraj & Company accepts his appointment as a statutory auditor u/s 224 of the Companies Act, 1956, of Beauty Cosmetics Ltd. (Nov. '93)
Hint Ans: Guilty as the ICAI has specified that a member in practice shall be deemed to be guilty if he accepts the appointment as auditor of a company while he is an employee of the cost auditor of the Company.

Q63. Mr. Fair, a practicing CA, was appointed to carry a B/S Audit of a NPO. The Internal Auditors detected certain irregularities at one of the branches of the organization, which Mr. Fair had failed to detect. Is there professional misconduct committed? (Nov 97)
Hint Ans: An auditor while discharging his responsibilities is expected to perform his duties by exercising reasonable care and skill. It may not be possible for an auditor doing B/S Audit to go deeply into these matters when some of them pertain to branches. He may not be held of guilty even if irregularities have been detected by internal auditors later.

QUESTIONS

Q1. Comment with reference to the CA Act, 1949 and Schedules thereto:

(a) Mrs. Fair is a Director of XYZ Private Limited, having 15% share-holdings in the company. During 2003, the company appointed C.A. Mr. Lovely, Mrs. Fair's spouse, as its statutory auditor. On Mr. Lovely's advice, the company issued fresh equity shares in 2003-04, in the ratio of one share for every two shares held by the shareholders of the company. Mr. Lovely used to deliver audit report for subsequent years without any comments or disclosures, thereupon. (4 Marks) **(Nov 2009)**

(b) Mr. A, a CA was the auditor of 'A Limited'. During the financial year 2007-08, the investment appeared in the B/S of the company of Rs. 10 lakhs and was the same amount as in the last year. Later on, it was found that the company's investments were only Rs. 25,000, but the value of investments was inflated for the purpose of obtaining higher amount of Bank loan. (4 Marks) **(Nov 2009)**

(c) Mr. B is a practicing CA holding a valid certificate of practice. He accepted appointment as Director of the Green World Co. Ltd. Mr. C, a partner of Mr. B is statutory auditor of the said company. (4 Marks) **(Nov 2010)**

(d) YKS & Co., a proprietary firm of CAs was appointed as concurrent auditor of a bank. YKS used his influence for getting some cheques purchased and thereafter failed to repay the loan/overdraft. (4 Marks) **(Nov 2010)**

(e) Mr. Mohan is a practicing CA. He issued a certificate of consumption which did not reflect the correct factual position of the consumption of raw material by the concerned entity. It is found that the certificate is given on the basis of data appearing in the minutes of meeting of the BOD. (4 Marks) **(Nov 2010)**

(f) CA Smart, a practicing CA was on Europe tour between 15-9-10 and 25-9-10. On 18-9-10 a message was received from one of his clients requesting for a stock certificate to be produced to the bank on or before 20-9-10. Due to urgency, CA Smart directed his assistant, who is also a CA, to sign and issue the stock certificate after due verification, on his behalf. (4 Marks) **(May 2011)**

(g) Mr. Kishore, a practicing CA was appointed by CG to carry out a special audit u/s 233A of the Companies Act, 1956. He accepted the appointment and proceeded with the work without communicating to the statutory auditor of the company. (4 Marks) **(May 2011)**

2. STANDARDS ON AUDITING

SA 200 - OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR & THE CONDUCT OF AN AUDIT IN ACCORDANCE WITH STANDARDS ON AUDITING

A. Objectives - In conducting an audit of Financial Statement (FS), the **overall objectives** of the auditor are:
i) To obtain reasonable assurance about whether the FS as a whole are **free from** material **misstatement**, whether due to **fraud or error**, thereby enabling the auditor to express an **opinion** on whether the FS are prepared, in all material respects**, in accordance with** an applicable financial reporting framework (FRF); and
ii) To report on the FS, and communicate as required by the SAs, in accordance with the auditor's findings.
In all cases when reasonable assurance cannot be obtained and a **qualified opinion** in the auditor's report is **insufficient** in the circumstances for purposes of reporting to the intended users of the FS, the SAs require that the auditor **disclaim an opinion** or **withdraw from the engagement**, where withdrawal is legally permitted.

B. Definitions -
i) Professional Judgment – The application of relevant training, knowledge and experience in making appropriate decisions during audit engagement.
ii) Professional Skepticism - An attitude that includes a **questioning mind being alert** to conditions indicating possible misstatement due to error or fraud and a critical assessment of audit evidence.

C. Requirements -
i) Ethical requirements - He shall **comply** with ethical requirements including independence. He is required to comply with code of ethics (issued by ICAI) which establishes the following as **fundamental principles** of professional ethics to the auditor when conducting an audit: • Integrity • Objectivity • Professional competence • due care • Confidentiality and • Professional behavior.
He shall be independent. Thus he can form an opinion without being affected by influences.

ii) Professional Skepticism - He shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause FS to be materially misstated. It includes **being alert to**, for **example**: • Contradictory evidences • Conditions indicating possible frauds • Conditions questioning reliability.
Moreover, it is necessary for critical assessment of audit evidences gathered. The auditor may accept documents and records as genuine unless the auditor has the reason to believe the contrary. In case of doubt, the SA requires that he should investigate further. By maintaining professional skepticism, overall risk can be reduced.

iii) Professional Judgment –
a. The auditor shall **exercise professional judgment** in planning and performing an audit.
b. It is necessary to **make proper decisions** during audit, particularly for taking decisions about: • Materiality • Audit Risk • Nature, Timing & Extent of Audit Procedure • Sufficiency & appropriateness of evidence etc.
c. Facts and circumstances that were known to the auditors **up to the date of auditor's report** can be used.
d. Consultation on difficult or contentious matters as required by revised SA 220 on "Quality control for an audit of FS" assist the auditor in making judgments.
e. It also needs to be appropriately **documented**.

iv) Sufficient & appropriate Audit Evidence and Audit Risk –
a. The auditor should obtain sufficient appropriate audit evidence **to reduce audit risk** to an acceptably low level and to draw reasonable conclusion.
b. '**Sufficiency**' refers to quantum of evidence, '**appropriateness**' refers to its quality.
c. '**Audit risk**' is a function of risk of material misstatements and detection risk. The assessment of audit risk is based on audit procedure to obtain information and evidence obtained throughout audit.
d. It is required to reduce audit risk to an acceptable low level. However, due to **inherent limitations** of audit, audit risk cannot be reduced to **Zero**.
e. The **quantity** of audit evidence needed is **affected by** the auditors' **assessment of risk**. The higher the assessed risk, the more audit evidence is likely to be required. And higher the quality, less audit evidence shall be required.
f. Whether sufficient appropriate audit evidence has been obtained is a matter of **professional judgment**. He should consider **SA 500** on "Audit Evidence".

v) Conduct of Audit in accordance with SAs
a. Complying with SAs Relevant to the audit - An SA is relevant if it is effective and **circumstances** stated in that SA **exist**. The auditor shall understand entire SA to apply it properly. He shall represent compliance with SAs in auditor's report only if he has complied with requirements of all relevant SAs.
b. Objectives stated in individual SAs - He shall determine whether any **additional audit procedure** is required to fulfill the objectives stated in SA and **evaluate** whether sufficient appropriate audit evidence has been obtained keeping in view the objectives stated in SA.
c. Complying with relevant requirement - He shall comply with **each requirement** of a SA **unless** • entire SA is not relevant or • requirement is not relevant because it is conditional & the condition is not present. However, in **exceptional circumstances**, he may depart from relevant requirement in SA. In such case, He shall perform **alternative procedures**. SA 230 on "Audit Documentation" establishes **documentation** requirement in such case.
d. Failure to achieve an objective in relevant SAs - In that case, he shall consider the need to **modify** the audit report, or **withdraw** from the engagement. It is a significant matter requiring **documentation** as well. SA 230 on "Audit Documentation" establishes documentation requirement in such case.

SA 210 - AGREEING THE TERMS OF AUDIT ENGAGEMENTS (REVISED)

A. Objective - The objective of the auditor is to **accept** or continue an audit engagement **only when** the basis upon which it is to be performed has been agreed, through:
i) Establishing whether the **preconditions** for an audit are **present;** and
ii) Confirming that there is a **common understanding** between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

B. Requirements –
i) a. Preconditions for an Audit - In order to establish whether the preconditions for an audit are present, the auditor shall:
• Determine whether the **financial reporting framework to be applied** in the preparation of the FS is acceptable; and
• Obtain the **agreement of management** that it acknowledges and understands its responsibility**:**
~ For the **preparation of the FS** in accordance with the applicable financial reporting framework, including where relevant their fair presentation;

~ For such **internal control** as management determines is necessary to enable the preparation of FS that are free from material misstatement, whether due to fraud or error;
~ To **provide the auditor** with:
→ **Access to all information** of which management is aware that is relevant to the preparation of the FS such as records, documentation and other matters;
→ **Additional information** that auditor may request management for purpose of audit;
→ **Unrestricted access** to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.
b. Limitation on Scope Prior to Audit Engagement Acceptance - If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the FS, the auditor **shall not accent** such a limited an audit engagement, **unless** required by **law** or regulation to do so.
c. Other Factors Affecting Audit Engagement Acceptance - If the preconditions for an audit are not present, auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor **shall not accept** the proposed audit engagement:
• If the auditor has determined that the financial reporting framework to be applied in the preparation of the FS is **unacceptable;** or
• If the **agreement** has **not been obtained.**

ii) Agreement Audit Engagement Terms (Principal Contents Of Audit Engagement Letter) - The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:
a. The **objective and scope** of the audit of the FS;
b. The **responsibilities** of the **auditor**;
c. The responsibilities of **management**;
d. Identification of the **financial reporting framework** for the preparation of FS;
e. Reference to the **expected form** and content of any **reports** to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.
If **law or regulation prescribes** in sufficient detail the terms of the audit engagement the auditor need **not record** them in a **written agreement**, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities as above.

iii) Recurring Audits - On recurring audits, the auditor shall assess whether **circumstances** require the **terms** of the audit engagement to be **revised** and whether there is a need to remind the entity of the existing terms of the audit engagement. The auditor may **decide not to send** a new audit engagement letter or other written agreement each period. However, the **following factors** may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:
a. Any indication that the entity **misunderstands** the objective and scope of the audit.
b. Any revised or **special terms** of the audit engagement
c. A recent **change** of senior **management.**
d. A significant change in **ownership.**
e. A significant change in nature or **size** of the **entity**'s business.
f. A **change** in **legal** or regulatory requirements.
g. A **change** in the financial **reporting framework** adopted in the preparation of the FS.
h. A change in other **reporting requirements**.

iv) Acceptance of a Change in the Terms of the Audit Engagement

a. The auditor shall **not agree** to a change in the terms of the audit engagement where there is **no reasonable justification** for doing so.

b. If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a **lower level of assurance**, the auditor shall determine whether there is **reasonable justification** for doing so.

c. If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of **written agreement.**

d. If the auditor is **unable to agree** to a change of the terms of the audit engagement & is **not permitted by** management to continue the original audit engagement, auditor shall:

• **Withdraw** from the audit engagement where possible under applicable law or regulation;

• Determine whether there is any **obligation,** either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

v) Additional Considerations in Engagement Acceptance

a) Financial Reporting Standards Supplemented by Law or Regulation - If financial reporting standards established by an authorized or recognized standards setting organization are supplemented by law or regulation, the auditor shall determine whether there are any **conflicts** between the financial reporting standards and the additional requirements. If such conflicts **exist**, the auditor shall discuss with management the nature of the additional requirements and shall agree whether:

• The additional requirements can be met through **additional disclosures** in the FS;

• The **description** of the applicable financial reporting framework in the FS can be **amended** accordingly.

If neither of the above actions is possible, the auditor shall determine whether it will be necessary to **modify** the auditor's opinion in accordance with SA 705

b. Financial Reporting Framework Prescribed by Law or Regulation - Other Matters Affecting Acceptance - If the auditor has determined that the financial reporting framework prescribed by law or regulation would be **unacceptable** but for the fact that it is prescribed by law or regulation, the auditor shall **accept** the audit engagement only if the **following conditions** are present:

• **Management agrees** to provide **additional disclosures** in the FS required to avoid the FS being misleading; and

• It is **recognized** in the **terms** of the audit engagement that:

~ The auditor's report on the FS will incorporate **an Emphasis of Matter paragraph**, drawing users' attention to the additional disclosures**,** in accordance with SA 706 (Revised);

~ Unless the auditor is required by law or regulation to express the auditor's opinion on the FS by using the phrases "**present fairly**, in all material respects' or "give a true and fair view" in accordance with the applicable financial reporting framework, the auditor's opinion on the FS will **not include such phrases**.

General Clarification (GC) – AASB/2/2004 ON SA 210, "Terms of Audit Engagement"

Question: 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?

Ans: When the objective and scope of the engagement and the auditor's obligations are laid down in the applicable statute or Regulations: 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. If, however, the client seeks any **further explanations or clarification,** he should take necessary steps to resolve the issues.
When 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

SA 220 - QUALITY CONTROL FOR AN AUDIT OF FS

A. Objective - The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:
i) The audit complies with professional standards and regulatory and legal requirements;
ii) The auditor's report issued is appropriate in the circumstances.

B. Basic Definitions
i) Engagement partner (EP) - partners / other person in firm (must be CA in full time practice) is responsible for engagement and report thereon.
ii) Engagement Quality Control Review - is a process to evaluate the judgment and conclusions of engagement team before report is issued.
iii) Network Firm - Entity under common control ownership or management with firm (nationally/internationally)
iv) Staff - Professionals other than partners.

C. Requirements –
i) Leadership responsibilities for quality on audits - The Engagement Partner (**EP**) shall take **overall responsibility** for the overall quality on each audit engagement to which that partner's is assigned.

ii) Relevant Ethical Requirements
a. Throughout the audit engagement, EP shall remain **alert for non compliance** with relevant ethical requirement by members of the engagement team
b. If members of audit team do **not comply**, the EP, in consultation with others in the firm, shall determine the appropriate **action.**

iii) Independence -
a. EP shall obtain relevant information to **identify circumstances** and relationship that create **threats to independence**.
b. EP shall evaluate information on identified **breaches** & take appropriate **action to eliminate** such threats or **reduce them** to an acceptable level. If consider appropriate, **withdraw** from the audit engagement, when permitted by law or regulation.

iv) Acceptance & continuance of client relationships & audit engagements -
a. The engagement partner shall be satisfied that appropriate **procedures** regarding the acceptance & continuance of client relationship & audit engagements have been **followed**.
b. If the EP obtains the **information** that would have caused the **firm to decline the audit engagement** had the information been available earlier, the EP shall **communicate** information promptly to the firm, so that the firm and EP can take necessary action.

v) Assignment of Engagement Teams - The EP shall be satisfied that the engagement team, collectively have the appropriate competence & capabilities:
a. Perform the audit engagement in accordance with **professional standard** and regulatory and legal requirements and
b. Enable an auditor's report that is appropriate in the **circumstances** to be issued

vi) Engagement Performance

a. Direction, Supervision and Performance - The engagement partner shall take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements, and the auditor's report being appropriate in the circumstances.

b. Reviews - The engagement partner shall take responsibility for reviews being performed in accordance with the **firm's review policies** and procedures. On or before the date of the auditor's report, the engagement partner shall, be satisfied that sufficient appropriate **audit evidence has been obtained** to support the conclusions and the auditor's report.

c. Consultation - The engagement partner shall take responsibility for the engagement team undertaking appropriate consultation of **difficult matters**. He shall be satisfied that engagement team has undertaken consultation both within the engagement team and between the engagement team & others and such **consultation** have been **implemented.**

d. Engagement Quality Control Review - For audits of FS of **listed entities** and those **other audit engagement** for which the engagement quality control reviews is required, the **EP** shall **determine** that an engagement quality control **reviewer** has been **appointed**. The engagement quality control reviewer shall **evaluate** the significant judgment and the conclusion reached. He shall evaluate the following:

- Discussion of **significant matters** with the EP
- Review of the **FS** and the proposed **auditor's report**
- Review of **selected audit documents**.
- Evaluation of **conclusions** reached.

For audits of FS of **listed entities**, the engagement quality control reviewer shall also consider the following:

- The engagement **team's evaluation** of the firms **independence**
- Whether appropriate **consultations** has taken place and the conclusions arising from those **consultations**

e. Differences of Opinion - If differences of opinion arise within the engagement team with those consulted or between the engagement partner and the engagement quality control reviewer, the engagement team shall **follow the firm's policies and procedures** for dealing with and resolving differences of opinion.

vii) Monitoring - A monitoring process is designed to provide the firm with reasonable assurance that its policies and procedures relating to quality control are relevant adequate and operating effectively. The engagement partner shall consider the **result** of the firms monitoring process.

viii) Documentation - The **auditors shall document** • Issues identified with respect to compliance with relevant ethical requirement and how they were resolved. • Conclusions on compliance with independence requirements. • Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements. • The consultations undertaken during the course of the audit engagement.

The engagement quality control reviewer shall document for the audit engagement reviewed that • The procedures for engagement quality control review have been performed. • The engagement quality control review has been completed on or before the date of the auditors reports and • The reviewer is not aware of any unresolved matters.

SA 230 - AUDIT DOCUMENTATION

A. Objective – The objective of the auditor is to prepare documentation that provides:

i) A sufficient and appropriate **record** of the basis for the auditor's report; and

ii) Evidence that the audit was planned and performed in accordance with **SAs** and applicable **legal** and regulatory requirements.

B. Requirements -
i) Timely Preparation of Audit Documentation – The auditor should prepare audit documentation on timely basis to enhance the quality of audit and for effective review and evaluation of audit evidence obtained and conclusion reached.

ii) Documentation of the Audit Procedures Performed & Audit Evidence Obtained –
a. Form, Content And Extent Of Audit Documentation - The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor to understand:
• The nature, timing, and extent of the **audit procedures**;
• The results of the audit procedures performed, and the **audit evidence** obtained; and
• **Significant matters** arising during the audit and the **conclusions** reached thereon.
Auditor shall also record:
• The identifying **characteristics** of the specific items or matters tested,
• **Who performed the** audit work and the date such work was completed; and
• **Who reviewed** the audit work performed and the date and extent of such review?
• He shall also **document discussion** of significant matters with management, those charged with governance & others.
If the auditor identified inconsistent information, the auditor shall **document** how he **addressed the inconsistency**.
b. Departure From A Relevant Requirement - If, in exceptional circumstances, he departs from SA, the auditor shall document the **reasons** for the departure and **alternative audit procedures** performed.
c. Matters Arising After The Date Of The Auditor's Report - If, in exceptional circumstances, the auditor performs new or **additional audit procedures** or draws new conclusions after the date of the auditor's report, the auditor shall document:
• The **circumstances** encountered;
• The new or **additional audit procedures performed**, audit evidence obtained, and conclusions reached and their effect on the auditor's report; and
• **When and by whom** the changes to audit documentation were made and reviewed.

iii) Assembly Of Final Audit File - The auditor shall assemble the audit documentation in an audit file & complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. After the assembly, the auditor shall **not delete** audit documentation before the end of its **retention period.**
SQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files which is ordinarily more than **60 days** after the date of auditor's report.
SQC 1 requires firms to establish policies and procedures for **retention** of engagement documentation. The retention period for audit engagements ordinarily is no shorter than **10 years** (However minimum retention period is **5 years**) from the date of the auditor's report or, if later the date of the group auditor's report.
However **changes** may be made to the audit documentation during the final assembly process if they are administrative in nature. **Examples** of such changes are:
a. Sorting, collating and cross referencing working papers
b. deleting or discarding superseded documentation
c. signing off on completion checklists relating to file assembly process

C. Ownership of Audit Documentation - SQC 1 provides that, **unless** otherwise specified by **law or regulation**, audit documentation is the property of auditor. He may at his **discretion,** make portions or extracts from, audit documentation **available to clients**, **provided** such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the auditor or of his personnel.

SA 240 - THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS

A. Objective - The objectives of the auditor are as follows:
i) To identify and assess the risks of material misstatement in the FS due to fraud;
ii) To obtain sufficient appropriate audit evidence about the assessed risks of material misstatement due to fraud; and
iii) To respond appropriately to identified or suspected fraud.

B. Definitions -
i) Fraud - An **intentional act** by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.
ii) Fraud Risk Factors - Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

C. Responsibility For The Prevention And Detection Of Fraud - The **primary** responsibility for the prevention and detection of fraud rests with both **those charged with governance (TCWG) of the entity and management**. Management and those charged with governance should place a strong emphasis in fraud prevention. This involves a commitment to creating a culture of honesty and ethical behavior.

D. Responsibilities Of The Auditor –
i) Auditors are responsible for **obtaining reasonable assurance** that the FS taken as a whole are **free from material mis statement**.
ii) As described in **SA 200,** due to the **inherent limitations** of an audit, there is an unavoidable risk that some material misstatements of the FS will not be detected, even though the audit is properly planned and performed in accordance with the SAs.
iii) The **risk of not detecting** a material misstatement resulting from **fraud is higher** than the risk of not detecting one resulting from error.
iv) This is because fraud involves **carefully organized schemes** designed to conceal it.
v) It is **difficult** for the auditor to determine whether misstatements in judgment areas such as **accounting estimates** are caused by fraud or error.
vi) The risk of the auditor not detecting a material misstatement resulting from **management fraud** is greater than for employee fraud as management can manipulate accounting records.
vii) The auditor is responsible for maintaining an attitude of **professional skepticism** throughout the audit.

E. Requirements -
i) Professional Skepticism –
a. The auditor shall maintain an attitude of professional skepticism throughout the audit.
b. He should **recognize the possibility that a material misstatement** due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance.
c. Unless **doubtful situations** are present, the auditor may accept records and documents as genuine.
d. If **conditions cause** the auditor to believe that document may not be authentic or that terms in a document have been modified, the auditor shall **investigate further**.
e. Where responses to **inquiries of management** or those charged with governance are inconsistent, the auditor shall **investigate** the inconsistencies.

ii) Discussion Among The Engagement Team - They should discuss **how and where** the entity's FS may be **susceptible** to material misstatement due to fraud, including how fraud might occur. The discussion shall occur notwithstanding the engagement team members' beliefs that management and those charged with governance are honest and have integrity.

iii) Risk Assessment Procedures And Related Activities – When performing risk assessment procedures, he shall perform the **following procedures**:
a. Enquiring Management and Others within the Entity - The auditor shall make inquiries of management regarding:
• Management's **assessment of the risk** of material misstatement due to fraud;
• Management's **process for identifying & responding** to the risks of fraud in the entity, including any specific risks of fraud;
• Management's **communication,** if any, to those charged with governance; and
• Management's **communication**, if any, to **employees** regarding its views on business practices and ethical behavior.
• For those entities that have an internal audit function, the auditor shall make **inquiries of internal auditor.**
b. Enquiring Those Charged with Governance (TCWG) – He shall obtain an understanding of how TCWG supervise management's processes. The auditor shall ask TCWG whether they have **knowledge** of any fraud affecting the entity.
c. Unusual or Unexpected Relationships Identified - The auditor shall **evaluate** whether unusual or unexpected relationships identified in performing **analytical procedures**, may indicate risks of material misstatement due to fraud.
d. Other Information - The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud.
e. Evaluation of Fraud Risk Factors - The auditor shall evaluate whether the information obtained, indicates that one or more fraud risk factors are present. However, fraud risk factors may not necessarily indicate the existence of fraud.

iv) Identification and Assessment of the Risks of Material Misstatement Due to Fraud - In accordance with SA 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level **for classes of transactions, account balances** and disclosures. The auditor shall, based on a **presumption** that there are **risks of fraud in revenue recognition**, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. The auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks.

v) Responses to the Assessed Risks of Material Misstatement Due to Fraud - In accordance with SA 330, the auditor shall **determine overall responses** to address the assessed risks of material misstatement due to fraud at the financial statement level.
a. Overall Responses - The auditor shall:
• Assign and supervise personnel as per their capability;
• Evaluate whether accounting policies adopted by the entity indicate fraudulent financial reporting resulting from management's effort to manage earnings; and
• Incorporate surprise element in the selection of the Nature Time Extent of audit procedures.
b. Response to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level - The auditor shall **design and perform further audit procedures** whose nature, timing and extent re responsive to the assessed risks of material misstatement due to fraud at the assertion level.
c. Responses to Risks Related to Management Override of Controls - Management is

in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent FS by overriding controls. It is a risk of material misstatement due to fraud and thus a significant risk. The auditor shall determine whether the auditor needs to perform **extra audit procedures**.

vi) Evaluation of Audit Evidence –
a. The auditor shall evaluate whether **analytical procedures** are **consistent** with the auditor's understanding of the entity and its environment.
b. When the auditor **identifies a misstatement**, the auditor shall evaluate whether such a misstatement is **indicative of fraud**. if there is such an indication, the auditor shall **evaluate** the implications of the misstatement in relation to **other aspects** of the audit, particularly the reliability of management representations.
c. If auditor identifies a misstatement; the auditor shall **re-evaluate** the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures.
d. When the auditor **confirms** that, or is **unable to conclude** whether, the FS are materially misstated as a result of fraud the auditor shall **evaluate the implications for the audit**.

vii) Auditor Unable to Continue the Engagement - The auditor shall:
a. Determine the **professional and legal responsibilities** applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
b. Consider whether it is appropriate to **withdraw** from the engagement; and
c. If the auditor withdraws:
• **Discuss** with the appropriate level of **management** and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and
• **Determine** whether there is a **professional or legal requirement** to report to person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

viii) Management Representations - Auditor should obtain written representations from management that:
a. Its **responsibility** for the design, implementation and maintenance of **internal control** to prevent and detect fraud;
b. It has **disclosed** to the auditor the **results** of its **assessment of the risk of fraud**;
c. It has **disclosed** to the auditor its **knowledge of fraud** or suspected fraud affecting the entity involving: • Management; • Employees who have significant roles in internal control; or • Others;
d. It has **disclosed** to the auditor its knowledge of any allegations of **fraud**, or suspected fraud, affecting the entity's FS.

ix) Communications to Management and TCWG - If the auditor has **identified a fraud** or has indication of fraud; the auditor shall communicate these matters on a timely basis to the appropriate level of management. The auditor shall communicate with those charged with governance other matters related to fraud that are **relevant** to their responsibilities.

x) Communications to Regulatory Authorities - The auditor's **legal responsibilities** may **override the duty of confidentiality** in some circumstances.

xi) Documentation - He shall maintain documentation as per SA 315 and SA 330. The auditor shall document, **communications** about fraud made to **management**, those charged with governance, regulators and others. When the auditor has concluded that

presumption that there is a risk of material misstatement due to **fraud related to revenue recognition** is not applicable in the circumstances of the engagement, the auditor shall document the **reasons** for that conclusion.

SA 250 - CONSIDERATIONS OF LAW AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

A. Objectives - The objectives of the auditor are:
i) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws & regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the FS;
ii) To perform specified audit procedures to help identify instances of noncompliance with other laws & regulations that may have a material effect on the FS; and
iii) To respond appropriately to non-compliance or suspected non-compliance with laws & regulations identified during the audit.

B. Responsibility Of Management For Compliance With Laws & Regulations - It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of **laws and regulations,** including compliance with the provisions of laws & regulations that determine the reported amounts and disclosures in an entity's FS.

C. Responsibility of Auditor - The requirements in this SA are designed to assist the auditor in identifying material misstatement of the FS due to non-compliance with laws and regulations. However, the auditor is **not responsible for preventing** non compliance and cannot be expected to detect non-compliance with all laws and regulations. In the context of laws and regulations, the potential effects of **inherent limitations** on the auditor's ability to detect material misstatements are greater. This SA distinguishes the auditor's responsibilities in relation to compliance with **two different categories** of laws and regulations as follows:
i) The provisions of those laws and regulations having a **direct effect** on the determination of material amounts and disclosures in the FS such as tax and labour laws;
ii) Other laws and regulations that do **not have a direct effect** on the determination of the amounts and disclosures in the FS, but compliance with which may be fundamental to the operating aspects of the business.

In this SA, different requirements are specified for each of the above categories of laws and regulations. For the category referred to in **C (i)** above, the auditor's responsibility is to **obtain sufficient appropriate audit evidence** about compliance with the provisions of those laws and regulations. For the category referred to in **C (ii)** the auditor's responsibility is **limited to undertaking specified audit procedures** to help **identify** non-compliance with those Laws and regulations that may have a material effect on the FS.

D. Requirements -
i) The Auditor's Consideration Of Compliance With Laws & Regulations - The auditor shall obtain a **general understanding** of:
a. The **legal and regulatory framework** applicable to the entity and the industry or sector in which the entity operates; and
b. How the entity is complying with that framework.
The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a **direct effect** on the determination of material amounts and **disclosures** in the FS. The auditor shall perform the

following audit procedures to identify instances of non-compliance with other laws and regulations that may have a material effect on the F.S.:
• **Inquiring** of management; and
• **Inspecting** correspondence, if any, with the relevant licensing or regulatory authorities.
During the audit, the auditor shall **remain alert** to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. **Obtain written representation** that all known instances of non-compliance or suspected non-compliance with laws and regulations have been disclosed to the auditor.

ii) Audit Procedures When Non- Compliance is Identified or Suspected - If the auditor becomes aware of information concerning an instance of non compliance or suspected non-compliance with laws and regulations, the auditor shall obtain:
a. An understanding of the nature of the **act** and the **circumstances** in which it has occurred;
b. Further information to evaluate the **possible effect** on the FS.
If the auditor suspects there may be non-compliance, the auditor shall discuss the matter with management and those charged with governance. If management or those charged with governance **do not provide sufficient information** the auditor shall consider the need to obtain **legal advice.** If sufficient information about suspected non-compliance cannot be obtained, the auditor shall **evaluate the effect** of the lack of sufficient appropriate audit evidence on the auditor's opinion.

iii) Reporting of identified or Suspected Non- Compliance
a. Reporting Non- Compliance to Those Charged with Governance - Unless all of those charged with governance are involved in management of the entity, the auditor shall **communicate** with those charged with governance matters involving non compliance with laws and regulations that come to the auditor's attention. If in the auditor's judgment, the non-compliance is believed to be **intentional and material**; the auditor shall communicate the matter to those charged with governance as soon as practicable. If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the **next higher level of authority** at the entity, if it exists, such as an audit committee or supervisory board. Where **no higher authority** exists, or if the auditor believes that the communication may not be acted upon, the auditor shall consider the need to obtain **legal advice**.
b. Reporting Non- Compliance in the Auditor's Report on the FS - If the auditor concludes that the non-compliance has a **material effect** on the FS, and has **not been adequately reflected** in the F.S., the auditor shall, express **a qualified or adverse opinion** on the FS. If the auditor is **precluded by management** or those charged with governance from obtaining sufficient appropriate audit evidence, the auditor shall express a qualified opinion or disclaim an opinion, lf the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall **evaluate the effect** on the auditor's opinion.
c. Reporting Non- Compliance to Regulatory and Enforcement Authorities - If the auditor has identified or suspect's non-compliance with laws and regulations, the auditor shall **determine** whether the auditor has a **responsibility to report** the identified or suspected non-compliance to parties **outside the entity**.

iv) Documentation - The auditor shall document identified or suspected non-compliance with laws and regulations and the results of **discussion with management** and those charged with governance and other parties outside the entity.

SA 260 - COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

A. Objective - The objectives of the auditor are to:
i) Communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
ii) Obtain from those charged with governance information relevant to the audit;
iii) Provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and
iv) Promote effective two-way communication between auditor and those charged with governance.

B. Definition - Those charged with governance - The person(s) or organization(s) (e.g., a corporate trustee) with "responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity.

C. When All of those Charged with Governance are Involved in Managing the Entity - In some cases, all of those charged with governance are involved in managing the entity, for example, a **small business** where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this SA are communicated with person(s) with management responsibilities, and those person(s) also have governance Responsibilities, the matters **need not be communicated" again** with those same person(s) in their governance role.

D. Requirements -
i) Those charged with Governance - The auditor shall **determine the appropriate person** within the entity's governance structure with whom to **communicate**.

ii) Matters to be Communicated -
a. The Auditor's Responsibilities in Relation to the Financial Statement Audit - The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:
• The auditor is responsible for **forming and expressing an opinion** on the F.S.
• The audit of the F.S. does **not relieve management** or those charged With governance of their responsibilities.
b. Planned Scope and Timing of the Audit - The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit.
c. Significant Findings from the Audit - The auditor shall communicate with those charged with governance:
• The auditor's **views** about **significant qualitative aspects** of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.
• **Significant difficulties**, if any, encountered during the audit;
• Unless all of those charged with governance are involved in managing the entity:
~ **Material weaknesses**, if any, in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention and have been communicated to management;
~ **Significant matters**, if any, arising from the audit that were discussed, or subject to correspondence with management; and
~ **Written representations** the auditor is requesting; and Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

d. Auditor Independence - In the case of **listed entities**, the auditor shall communicate with those charged with governance:
a. A **statement** that the engagement team and others in the firm as appropriate, have complied with relevant **ethical requirements** regarding independence; and
b. All **relationships** and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence.
c. The **related safeguards** that have been applied to **eliminate identified threats** to independence or reduce them to an acceptable level.

iii) The Communication Process
a. Establishing the Communication Process – The auditor shall communicate with those charged with governance the form, timing and expected general content of communications.
b. Forms of Communication - The auditor shall communicate in **writing** with those charged with governance regarding **significant matters**. The auditor shall communicate in writing with those charged with governance regarding auditor independence.
c. Timing of Communications – The auditor shall communicate with those charged with governance on a **timely basis**.
d. Adequacy of the Communication Process - The auditor shall **evaluate** whether the **two-way communication** between the auditor and those charged with governance has been **adequate** for the purpose of the audit. **If it has not**, the auditor shall evaluate the **effect** on the auditor's assessment of the risks of material misstatement,

iv) Documentation - Where matters required by this SA to be communicated are communicated **orally,** the auditor shall document them, and **when and to whom** they were communicated. Where matters have been communicated **in writing**, the auditor shall **retain a copy** of the communication as part of the audit documentation.

SA 265 - COMMUNICATING DEFICIENCIES IN INTERNAL CONTROL TO THOSE CHARGED WITH GOVERNANCE (TCWG) & MANAGEMENT

A. Objective – Objective of the auditor is to communicate to TCWG & management deficiencies in IC that auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

B. Definitions –
i) Deficiency In Internal Control - This exists when:
a. A control is designed, implemented or operated in such a way that it is **unable to prevent** or detect and correct, **misstatements** in the FS on a timely basis; or
b. A **control necessary to prevent**, or detect and correct, misstatements in the FS on a timely basis **is missing**.

ii) Significant Deficiency In Internal Control (IC) - A deficiency or combination of deficiencies in IC that, in the auditor's professional judgment, is of **sufficient importance to merit the attention of TCWG.**
Examples of matters that the auditor may consider in determining whether a deficiency or combination of deficiencies in IC constitutes a significant deficiency
a. The **likelihood of the deficiencies** leading to material misstatements in F.S. **in future**
b. The **susceptibility to loss or fraud** of the related asset or liability
c. The FS **amounts** exposed to the deficiencies
d. The **subjectivity & complexity** of determining estimated amounts, such as fair value accounting estimates

e. The **importance of the controls** to the financial reporting process, for example:
• General monitoring controls • Controls over the prevention & detection of fund • Control over the selection and application of significant accounting policies. • Control over significant transactions with related parties. • The cause & frequency of the exceptions detected etc.
ii) Absence of a **risk assessment process**
iii) Evidence of **ineffective response** to identified risks
iv) Disclosure of material misstatement due to error or fraud as prior period items in the current year's statement of profit & loss.

C. <u>Requirements</u> –
i) The auditor shall **determine** whether, on the basis of the audit work performed, the auditor has **identified one or more deficiencies** in IC.

ii) If the auditor has identified one or more deficiencies in IC, the auditor shall determine they constitute **significant deficiencies**.

iii) The auditor shall **communicate in writing** significant deficiencies in IC identified during the audit to TCWG on a timely basis.

iv) The auditor shall also communicate **to management** at an appropriate level of responsibility on a timely basis:
a. In writing, **significant deficiencies** in IC that the auditor has communicated to TCWG.
b. Other deficiencies in IC identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention.

v) The auditor shall include in the **written communication** of significant deficiencies in IC:
a. A **description** of the deficiencies and an explanation of their potential effects; and
b. Sufficient information to enable TCWG and management to understand the context of the communication. In particular, the auditor shall **explain** that:
• The **purpose** of the audit was for the auditor to express an opinion on the F.S.;
• The audit included consideration of IC relevant to the preparation of the F.S. in order to design audit procedures that are appropriate in the circumstances, but **not for** the purpose of expressing an **opinion on the effectiveness of IC**; and
• The **matters** being reported are **limited to** those **deficiencies** that the auditor has **identified** during the audit and that the auditor has concluded are of sufficient importance

SA 299 - RESPONSIBILITY OF JOINT AUDITORS (JA)

A. <u>Joint Auditors</u> - when two or more practicing units are appointed to conduct audit of an entity.

B. <u>Division Of Work</u> -
i) Where Joint Auditors (JA) are appointed, they should, **by mutual discussion, divide** the audit works among them. The division of work would **usually** be in **terms of audit** of identifiable Units or specified areas. In some cases, due to nature of the business of entity under audits such a division of work may **not be possible**. In such situations, division of work may be with reference to items of **assets or liabilities or income or expenditure or** with reference to periods of **time**.
ii) The division of work among JA as well as the areas of work to be covered by all of them should be adequately **documented** and preferably **communicated to the entity**.

C. Co-ordination - If some JA comes to know a **matter, relevant for other JA,** then he should **communicate** it immediately in writing to other JA. The **date** of such communication should be **before** date of **audit report**.

D. Relationship Among JAs - In respect of audit work divided among the JAs each JA is **responsible** only for the **work allocated** to him, whether or not he has prepared a separate report on the look performed by him. On the other hand, all the JA are **jointly & severally responsible**:
i) In respect of the audit **work** which is **not divided** among the JA and is carried out by all of them
ii) In respect of **decisions taken by all** the JA concerning the nature, timing, or extent of the **audit procedures** to be performed by any of the JA.
iii) In respect of **matters** which are bought to the notice of the JAs by any one of them and on which there is an agreement among the JAs.
iv) For examining that the FS comply with the **disclosure requirements** of the relevant statute.
v) For ensuing that the audit report completes with the requirements of **relevant statute.**
vi) However, If any matters of the nature referred to in "C" above are **brought to the attention** of the entity or other JAs by an auditor **after the audit report** has been submitted, the other JAs would **not be responsible** for those matters.

E. Each JA is entitled to assume that the other JAs have carried out their part of the audit work in accordance with the **GAAP**. Each JA is entitled to rely upon other JA for bringing to his **notice** any **departure** from **GAAP** or any **material error** noticed in the course of audit.

F. Where separate FS of **division / branch** are audited by **one of the JAs**, the other JA are entitled to proceed on the basis that such FS **comply** with all the legal & professional **requirements** regarding the disclosures to be made and present a true & fair view of the state of affairs and of the working results of the division **/** branch concerned, subject to such observations as may be communicated by the JA concerned.

G. Reporting Responsibilities - Normally, the JAs are able to arrive at an **agreed report**. However, where the JAs are in **disagreement** with regard to any matters to be covered by the report, each one of them should express his own opinion through a **separate report.** A JA is **not bound by** the views of the **majority** of the JAs regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.

SA 300 - PLANNING AN AUDIT OF FINANCIAL STATEMENTS

A. Objective - The objective of the auditor is to plan the audit so that it will be performed in an effective manner.

B. Requirements -
i) Involvement of Key Engagement Team Members - The engagement partner (EP) and other **key members** of the engagement team shall be involved in planning the audit.

ii) Preliminary Engagement Activities - The auditor shall undertake the following activities at the beginning of the current audit engagement:
a. performing procedures required by **SA220** regarding continuance of client relationship
b. Evaluating compliance with ethical requirements, independence, required by SA 220;
c. Establishing an understanding of the terms of the engagement, as required by SA 210.

iii) Planning Activities - The auditor shall establish an '**overall audit strategy'*** that sets the scope, timing & direction of audit that guides the development of the audit plan.

***The Overall Audit Strategy -** The process of establishing the overall audit strategy assists the auditor to determine such matters as:
a. The **resources** to deploy for specific audit area, such as the use of appropriately team members for high risk area or the involvement of experts on complex matters.
b. The **amount of resources to allocate** to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, audit budget.
c. When these resources to be **deployed,** such as interim audit stage/key cut-off dates.
d. How such resources are **managed**, directed & supervised, such as when team briefing & debriefing meetings are expected to be held.
In establishing the overall audit strategy, the auditor shall:
a. Identify the **characteristics** of the engagement that define its scope;
b. Ascertain the **reporting objectives** of the engagement to plan the timing of the audit and the nature of the communications required;
c. Consider the **factors** that are **significant** in directing the engagement team's efforts;
d. Consider the **results** of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the EP for the entity is relevant; and
e. Ascertain the **NTE** of procedures.

The auditor shall develop an "Audit Plan" that shall include a description of:**
a. The NTE of **planned risk assessment procedures**, as determined under SA 315.
b. The NTE of planned **further audit procedures** at the assertion level, as determined under SA 330.
c. Other planned audit procedures that are required to be carried out so that the engagement complies with SAs. The auditor shall **update and change** the overall audit strategy and the audit plan as necessary during the course of the audit. He shall plan the NTE of direction and supervision of engagement team members & the review of their work.

****Audit Plan** - The Audit Plan is **more detailed than the overall audit strategy** that **includes** the nature, timing & extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for engagement develops. For e.g. planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing & extent (NTE) of specific further audit procedures depends on the outcome of those Risk Assessment Procedures.

Changes to planning Decisions during the course of the Audit - As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to **modify the overall audit strategy & audit plan** and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks.

iv) Documentation - The auditor shall document:
a. The overall **audit strategy**;
b. The **audit plan**; and
c. Any **significant changes** made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

v) Additional Considerations in Initial Audit Engagements - The auditor shall undertake the following activities prior to starting an initial audit:

a. Performing procedures required by **SA 220** regarding the acceptance of the client relationship and the specific audit engagement; and
b. Communicating with the **predecessor auditor**, where there has been a change of auditors, in compliance with relevant ethical requirements.

C. Considerations Specific to Smaller Entities - Many audits of small entities involve the engagement partner working with one engagement team member. With a **smaller team, co-ordination** of, and **communication** between, team members are **easier**. Establishing the **overall audit strategy** for the audit of a small entity need **not be a complex or time-consuming exercise;** it varies according to the size of the entity, the complexity of the audit, and the size of the engagement team.

SA 315 - IDENTIFYING AND ASSESSING THE RISK OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

A. Objective - The auditor should identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels. He should understand the entity and its environment, including the entity's internal control. Thus, he can design and implement responses to the assessed risks of material misstatement. This will help the auditor to reduce the risk of material misstatement to an acceptably low level.

B. Definitions -
i) Assertions - Representations by management, explicit or otherwise, embodied in the FS.
ii) Business Risk - A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives.
iii) Significant Risk - An identified and assessed risk of material misstatement that requires special audit consideration.

C. Requirements -
i) Risk Assessment Procedures and Related Activities - Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. The risk assessment **procedures** shall **include** the following:
a. Inquiries of management and of others within the entity
b. Analytical procedures.
c. Observation and inspection.
The auditor shall consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement. Where engagement partner (EP) has performed **other engagements** for the entity, consider whether information obtained is relevant to identifying risks of material misstatement. If auditor uses his **previous experience**, consider if changes have occurred since the previous audit. The EP and other key engagement team members shall discuss the susceptibility of the entities FS to material misstatement.

ii) The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control
a. The Entity and Its Environment - The auditor shall obtain an understanding of:
• Relevant industry, regulatory, and other **external factors**
• The **nature of the entity** including:
~ its operations; **~** Its ownership and governance structures;
~ the types of investments; **~** the way that the entity is structured and how it is financed;
• Entity's selection & application of **accounting policies,** including reasons for changes.
• The **entity's objectives and strategies**, and those related business risks that may result in risks of material misstatement

• The measurement and review of the entity's **financial performance**

b. The Entity's Internal Control - The auditor shall obtain an **understanding** of IC relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, **not all controls** that relate to financial reporting are **relevant** to audit

c. Nature and Extent of the understanding of Relevant Controls – He will **evaluate the design of controls** and determine whether they have been **implemented**.

d. Components of Internal Control:

• **The Control Environment –** The auditor shall evaluate whether:

~ Management & TCWG has created & maintained culture of **honesty & ethical behavior.**

~ The **strength** in the control environment provides an appropriate **foundation** for the other components of IC.

• **The Entity's Risk Assessment Process** –

~ Consider if **entity has a process** for:

→ Identifying **business risks** relevant to financial reporting objectives;

→ Estimating the **significance** of the risks;

→ Assessing the likelihood of their **occurrence**; and

→ Deciding about **actions** to address those risks.

~ If the entity has established **entity's risk assessment process**, the auditor shall obtain an understanding of it, and the results thereof.

~ If the entity has **not established** such a process or as an adhoc process, the auditor shall **discuss** with management whether **business risks** relevant to financial reporting objectives have been **identified** and how they have been addressed.

• **The Information System, Including the Related Business Processes, Relevant to Financial Reporting, And Communication.**

~ The auditor shall obtain an understanding of the following areas:

→ The **classes of transactions**

→ The **procedures** within both IT and manual systems, by which those transactions are initiated, recorded, processed and reported in the FS.

→ The related **accounting records**

→ **How** the **information system** captures events and conditions, other than transactions, that are significant to the FS.

→ The financial **reporting process**

→ **Controls** surrounding journal entries

~ The auditor shall obtain an understanding of:

→ Communications between management & TCWG

→ External communications, such as those with regulatory authorities.

• **Control Activities Relevant To the Audit.**

~ The Auditor shall obtain an **understanding of control** to assess the risks of material mis-statement at the assertion level & design further audit procedures.

~ In understanding the entity's control activities the auditor shall obtain an **understanding of how** the entity has **responded to risks** arising from it.

• **Monitoring of Controls -** Obtain an understanding of the:

~ activities that the entity uses **to monitor** internal control over financial reporting, and

~ Sources of the information used in entity are monitoring activities and their reliability.

iii) Identifying and Assessing the Risks of Material Misstatement

The auditor shall identify and assess the risks of material misstatement at:

a. The **financial statement level**; and

b. The **assertion level** for classes of transactions, account balances, and disclosures; to provide a basis for designing and performing further audit procedures.

For this purpose, the auditor shall:

a. Identify risks,

b. Assess and evaluate the identified risks,

c. Relate the identified risks to what can go wrong at the assertion level,
d. Consider the likelihood of misstatement.

Risks that Require Special Audit Consideration - In exercising judgment as to which risks are significant risks, the auditor shall consider the **following:**
a. Whether the **risk** is a risk of **fraud;**
b. Risk is related to recent **significant** economic, accounting, or other **developments;**
c. The **complexity** of transactions;
d. Whether the risk involves **significant transactions** with **related parties**;
e. The **degree of subjectivity** in the measurement of financial information; and
f. Whether the risk involves significant **unusual transactions.**

Risks for which Substantive Procedures alone Do Not Provide Sufficient Appropriate Audit Evidence - Such risks may relate to the **inaccurate or incomplete recording** of routine and significant classes of transactions or account balances, the characteristics of which often permit **highly automated processing** with little or no manual intervention. In such cases, the **entity's controls over such risks** are relevant to the audit and the auditor shall obtain an understanding of them.
Revision of Risk Assessment - The auditor's assessment of the risks of material misstatement at the assertion level may **change** during the course of the audit as additional audit evidence is obtained. The auditor shall revise the assessment and **modify** the further planned **audit procedures** accordingly.

iv) Material Weakness in Internal Control - The auditor shall **evaluate** whether, on the basis of the audit work performed, the auditor has identified a material weakness in the design, implementation or maintenance of internal control.
The auditor shall **communicate** material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility, and, as required by **SA 260** "Communication with Those Charged with Governance", with TCWG (unless all of TCWG are involved in managing the entity).

v) Documentation - The auditor shall document:
a. The **discussion** among the engagement team and the significant decisions reached;
b. Key elements of the **understanding** obtained regarding each of the aspects of the entity and its **environment** and of each of the internal control **components**; the sources of information from which the understanding was obtained; and the risk **assessment procedures** performed;
c. The **identified and assessed risks of material misstatement** at the financial statement level and at the assertion level; and
d. The **risks identified, and related controls** about which the auditor has obtained an understanding.

SA 320 - MATERIALITY IN PLANNING & PERFORMING AN AUDIT

A. Objective - The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

B. Materiality In The Context Of An Audit – **Financial Reporting Framework** (FRF) often discuss the concept of materiality in context of preparation and presentation of FS. If the applicable FRF does not include a discussion of concept of materiality, the following characteristics determines it:
i) Misstatements, including omissions, are material if they, individually or in aggregate, could be expected to influence the economic decisions of users taken on the basis of FS;

ii) Judgments about materiality are made in the light of **surrounding circumstances**, and are affected by the **size or nature** of a misstatement,; and
iii) Judgments about matters that are material to users of the FS are based on a consideration of the **common financial information needs** of users as a group.
iv) The auditor's determination of materiality is a matter of **professional judgment**, and is affected by the auditor's perception of the financial information **needs of users** of the FS.
v) In planning the audit, the auditor makes judgments about the **size of misstatements** that will be considered material. These judgments provide a basis for:
a. Determining the nature, timing and extent of risk **assessment procedures**;
b. Identifying and assessing the **risks** of material misstatement; and
c. Determining the nature, timing and extent of **further audit procedures**.
vi) Auditor considers not only the size but also the **nature** of uncorrected misstatements, when evaluating their effect on the FS.

C. Performance Materiality – **(i)** It means the amount or amounts set by the auditor **at less than materiality for the FS as a whole** to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the FS as a whole. **(ii)** If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels **for particular classes of transactions,** account balances or disclosures.

D. Requirements -
i) Determining Materiality and Performance Materiality when Planning the Audit –
a. When establishing the overall audit strategy, the auditor shall determine **materiality for the FS as a whole**.
b. If, there is **one or more particular item** for which misstatements of **lesser amounts** than the materiality for the FS as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the FS, the auditor shall also determine the **materiality level** or levels to be applied to those particular items.
c. The auditor shall **determine performance materiality** for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.

ii) Revision as the Audit Progresses –
a. The auditor shall **revise materiality** for the FS as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.
b. If the auditor concludes that a **lower materiality** for the FS as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to **revise performance materiality**, and whether the nature, timing and extent of the further audit procedures remain appropriate.

iii) Documentation - The audit documentation shall include the following amounts and the **factors** considered in their determination:
a. Materiality for the FS as a **whole;**
b. If applicable, the **materiality level** or levels for **particular classes** of transactions, account balances or disclosures;
c. Performance materiality; and
d. Any **revision** of (a)-(c) as the audit progressed.

SA 330 - THE AUDITOR'S RESPONSE TO ASSESSED RISKS

A. Objective - The objective of the auditor is to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

B. Definitions -
i) Substantive Procedure - An audit procedure **designed to detect material misstatements** at the assertion level. Substantive procedures comprise:
a. Tests of details (of classes of transactions, account balances, and disclosures), and
b. Substantive analytical procedures.
ii) Test of Controls - An audit procedure designed to **evaluate the operating effectiveness of controls** in preventing, or detecting and correcting, material misstatements at the assertion level.

C. Requirements -
i) Overall Responses - The auditor shall **design and implement** overall responses to address the assessed risks of material misstatement at the FS level.

ii) Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level –
a. Further Audit Procedures - The auditor shall **design and perform** further audit procedures whose nature, timing & extent are based on and are responsive to the assessed risks of material misstatement at the assertion level, in designing the further audit procedures to be performed. The auditor shall:
• **Consider** the likelihood of material misstatement due to the particular characteristics of relevant **class of transactions**, account balance, or disclosure (i.e., the inherent risk); and whether the risk assessment takes into account the relevant controls (i.e., the control risk)
• **Obtain more persuasive audit evidence,** the higher the auditor's assessment of risk.
b. Tests of Controls - The auditor shall design and perform tests of controls when:
• He expects that the controls are **operating** effectively, or.
• **Substantive procedures alone cannot provide** sufficient appropriate **audit evidence** at the assertion level.
c. Timing of Tests of Controls - The auditor shall test controls for the particular time, or throughout the period.
d. Using Audit Evidence Obtained During an Interim Period - When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:
• Consider **significant changes** to those controls; and
• Determine the **additional audit evidence** to be obtained for the remaining period.
e. Using Audit Evidence Obtained In Previous Audits - He shall establish the continuing relevance of that evidence by obtaining audit evidence about whether **significant changes in those controls** have occurred subsequent to the previous audit.
• If there have been changes, the auditor shall **test the controls** in the current audit.
• If there have **not** been such changes, the auditor shall **test the controls at least once in every third audit**, and shall **test some controls each audit**.
f. Controls Over Significant Risks – When the auditor plans to rely on controls over a significant risk, the auditor shall **test** those controls in the current period.
g. Evaluating the Operating Effectiveness of Controls - Auditor should consider whether **misstatements** that have been detected **indicate** that **controls** are **not operating** effectively. Even if there are no identified misstatements, controls may not be effective. The auditor shall **communicate** material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level and TCWG.

h. Substantive Procedures - Irrespective of the assessed risks of material misstatement, the auditor shall **design and perform** substantive procedures **for each material class** of transactions, account balance, and disclosure.
Substantive Procedures Related to the FS Closing Process - The auditor's substantive procedures shall include:
• Agreeing or **reconciling** the FS with the underlying accounting records;
• **Examining material journal entries** and other adjustments made during the course of preparing the FS.
Substantive Procedures Responsive to Significant Risks - When the auditor has determined a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk.
Timing of Substantive Procedures - When substantive procedures are performed at an interim date, the auditor shall cover the remaining period.

iii) Adequacy of Presentation and Disclosure - The auditor shall perform audit procedures to evaluate whether the overall presentation of the FS, including the related disclosures, is in accordance with the **applicable FRF.**

iv) Evaluating the Sufficiency and Appropriateness of Audit Evidence - The auditor shall conclude whether sufficient appropriate audit evidence has been obtained, in forming an opinion, the auditor shall consider all relevant audit evidence. If the auditor has **not obtained** sufficient appropriate audit evidence as to a material FS assertion, try to obtain **further audit evidence**. If the auditor is **unable** to obtain sufficient appropriate audit evidence, the auditor shall express a **qualified opinion or a disclaimer of opinion**.

v) Documentation - The auditor shall document:
a. The overall responses to **address assessed risks** of material misstatement at FS level;
b. The **linkage** of those procedures with the **assessed risks** at the assertion level; and
c. Results of the audit procedures.

If he uses audit evidence about the operating effectiveness of controls obtained in **previous audits**, the auditor shall **document the conclusions** reached about relying on such controls that were tested in a previous audit. The auditors' documentation shall demonstrate that the FS **agree or reconcile** with the underlying accounting records.

SA 402 - AUDIT CONSIDERATIONS RELATING TO AN ENTITY USING A SERVICE ORGANISATION

A. Objective - The objectives of the user auditor, when the user entity uses the services of a service organisation, are:
i) To obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement; and
ii) To design and perform audit procedures responsive to those risks.

B. Definitions -
i) Complementary User Entity Controls - Controls that the service organisation assumes, in the design of its service, will be implemented by user entities.

ii) Report On The Description And Design Of Controls At A Service Organisation (Referred to in this SA as a Type 1 Report) - A report that comprises:
a. A **description, prepared by management** of the service organisation, of the service organisation's system, control objectives and related controls that have been designed and

implemented as at a specified date; and
b. A **report** by the service auditor with the objective of conveying reasonable assurance that includes the **service auditor's opinion** on the description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives.

iii) Report On The Description, Design, And Operating Effectiveness Of Controls At A Service Organisation (Referred to in this SA as a Type 2 Report) - A report that comprises:
a. A **description, prepared by management** of the service organisation, of the service organisation's system, control objectives and related controls, their design and implementation as at a specified date or throughout a specified period and, in some cases, their operating effectiveness throughout a specified period; and
b. A **report** by service auditor with objective of conveying reasonable assurance includes:

- The service **auditor's opinion** on the description of the service organisation's system, control objectives and related controls, the suitability of design of controls to achieve the specified control objectives, and the operating effectiveness of the controls; and
- A **description** of the service **auditor's tests of the controls** and the **results** thereof.

iv) Service Auditor - An **auditor** who, at the request of the service organisation, provides an assurance report on the controls **of a service organisation**.
v) Service Organisation - A **third-party organisation** (or segment of a third-party organisation) that **provides services to user entities** that are part of those entities' information systems relevant to financial reporting.
vi) Subservice Organisation - A service organisation used by another service organisation to perform some of the services provided to user entities.
vii) User Auditor - An **auditor** who audits and reports on the FS of a **user entity**.

E. Requirements -
i) Obtaining an Understanding of the Services Provided by a Service Organisation, including IC - When obtaining an understanding of the user entity in accordance with SA 315, the user auditor shall obtain an **understanding** of **how a user entity uses the services** of a service organisation in the user entity's operations, including:
a. The **nature of the services** provided by the service organisation and the **significance** of those services to the user entity.
b. The **nature and materiality** of the **transactions processed** or accounts or financial reporting processes affected by the service organisation;
c. The **degree of interaction** between the activities of the service organisation and those of the user entity; and
d. The **nature of the relationship** between the user entity and the service organisation, including the relevant contractual terms.

The user auditor shall **evaluate** the design and implementation of **relevant controls at the user entity** that relate to the services provided by the service organisation. The user auditor shall determine whether a sufficient understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit has been obtained, the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain that understanding from one or more of the **following procedures**:
a. Obtaining a **Type 1 or Type 2 report**, if available;
b. Contacting the service org through the user entity to obtain specific information;
c. Visiting the service org and performing procedures; or

d. Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organisation.

Using a Type 1 or Type 2 Report to Support the User Auditor's Understanding of the Service Organisation - In determining the sufficiency and appropriateness of the audit evidence provided by Type 1 or Type 2 report, the user auditor shall be satisfied as to:
a. The service auditor's **professional competence** (except where the service auditor is a member of the ICAI) and independence from the service organisation; and
b. The **adequacy of the standards** under which the Type 1 or Type 2 report was issued

ii) Responding to the Assessed Risks of Material Misstatement - In responding to assessed risks in accordance with SA 330, the user auditor shall:
a. Determine whether sufficient appropriate **audit evidence** concerning the relevant FS assertions is available from **records** held at the user entity; and, if not,
b. Perform **further audit procedures** to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.
Tests of Controls - When the user auditor's risk assessment includes an expectation that controls at the service organisation are operating effectively; the user auditor shall obtain audit evidence about the operating effectiveness of those controls from one or more of the following procedures:
a. Obtaining a Type 2 report, if available;
b. Performing appropriate **tests of controls** at the service organisation; or
c. Using another auditor to perform tests of controls at the service organisation on behalf of the user auditor.

iii) Type I and Type 2 Reports that Exclude the Services of a Subservice Organisation - If user auditor **plans to use** a Type 1 or a Type 2 **report** that **excludes** the services provided by a subservice organisation and those services are **relevant** to the audit of the user entity's FS, the user auditor **shall apply the requirements of this SA** with respect to the services provided by the subservice organisation also.

iv) Fraud, Non- Compliance with Laws and Regulations and Uncorrected Misstatements in Relation to Activities at the Service Organisation - The user auditor shall **inquire of management of the user entity** whether the service organisation has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, noncompliance with laws and regulations or uncorrected misstatements affecting the FS of the user entity. The user auditor shall **evaluate** how such matters affect the nature, timing and extent of the **user auditor's further audit procedures**, including the **effect** on the user auditor's conclusions and user auditor's report.

v) Reporting by the User Auditor - The user auditor shall **modify the opinion** in user auditor's report, if user auditor is **unable to obtain** sufficient appropriate audit evidence regarding the services provided by the service organisation. The user auditor shall **not refer to the work of a service auditor** in user auditor's report containing an unmodified opinion. If **reference** to the work of a service auditor is **relevant** to an understanding of a modification to the user auditor's opinion; the user auditor's report shall **indicate** that such reference does **not diminish** the **user auditor's responsibility** for that opinion.

SA 450 - EVALUATION OF MIS-STATEMENTS IDENTIFIED DURING THE AUDIT

A. Objective - The objective of the auditor is to evaluate:
i) The effect of identified misstatements on the audit; and
ii) The effect of uncorrected misstatements, if any, on the FS.

B. i) Uncorrected Misstatements - Misstatements that the auditor has accumulated during the audit and that have not been corrected.
ii) Misstatements may result from:
a. An inaccuracy in gathering or processing data from which the FS are prepared.
b. An omission of an amount of disclosure
c. An incorrect accounting estimate arising from overlooking or clear misinterpretation of facts and
d. Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

C. Requirements -
i) Accumulation of Identified Misstatements - The auditor shall **accumulate** misstatements identified during the audit, **other than** those that are **clearly trivial**.

ii) Consideration of Identified Misstatements as the Audit Progresses - The auditor shall determine whether the **overall audit strategy and audit plan** need to be **revised** if:
a. The nature of identified misstatements and the circumstances of their occurrence indicate that **other misstatements may exist** that, when aggregated with misstatements accumulated during the audit, could be material; or
b. The **aggregate of misstatements** accumulated during the audit approaches **materiality**. If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall **perform additional audit procedures** to determine whether misstatements remain.

iii) Communication and Correction of Misstatements - The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, **unless prohibited by law** or regulation. The auditor shall **request** management to correct those misstatements. If management **refuses to correct** some or all of the misstatements communicated by the auditor, the auditor shall obtain an **understanding of management's reasons** for not making the corrections.

iv) Evaluating the Effect of Uncorrected Misstatements - Prior to evaluating the effect of uncorrected misstatements, the auditor shall **reassess materiality** determined in accordance with SA 320 (Revised) to confirm whether it remains appropriate in the context of the entity's actual financial results. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this detestation, the auditor shall consider:
a. The **size and nature** of the misstatements and the FS as a whole; and
b. The **effect** of uncorrected misstatements related to prior periods on the relevant and the FS as a whole.
Communication with Those Charged with Governance - The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall **identify** material uncorrected misstatements **individually**. The auditor shall request that uncorrected misstatements be corrected. The auditor shall also **communicate** with those charged with

governance the **effect** of uncorrected misstatements related to prior periods.

v) Written Representation - The auditor shall request a **written representation** from management and, where appropriate, those charged with governance whether they believe the **effects of uncorrected misstatements are immaterial,** individually and in aggregate, to the FS as a whole. A **summary** of such items shall be included in or attached to the written representation.

vi) Documentation - The audit documentation shall include:
a. The **amount below which** misstatements would be regarded as clearly trivial.
b. All misstatements **accumulated** during the audit & whether they have been corrected;
c. The auditor's **conclusion** as to whether uncorrected misstatements are **material**, individually or in aggregate and the basis for that conclusion

SA 500 - AUDIT EVIDENCE

A. Objective - The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

B. Definitions –
i) Appropriateness (Of Audit Evidence) - The measure of the **quality** of audit evidence; i.e., its relevance & its reliability in providing support for conclusions on which auditor's opinion is based.
ii) Management's Expert - An **individual or organisation possessing expertise** in a field **other than accounting or auditing**, whose work in that field is used by the entity to assist the entity in preparing the FS.
iii) Sufficiency (Of Audit Evidence) - The measure of the **quantity** of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

C. Requirements -
i) Sufficient Appropriate Audit Evidence - The auditor shall design and perform audit procedures that are **appropriate in the circumstances** for the purpose of obtaining sufficient appropriate audit evidence.
a. Audit procedures for obtaining Audit Evidence - As required by SA 315 & SA 330 audit evidence to **draw reasonable conclusions** on which to base the auditor's opinion is obtained by performing:
• **Risk Assessment Procedures; and**
• **Further audit procedures**, which comprise of test of controls & substantive procedures including tests of details and substantive analytical procedure.
b. Inspection - Inspection consists of **examining records**, documents or tangible assets. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media. An **example** of inspection used as a test of controls is inspection of records for evidence of authorisation. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets.
c. Observation - Observation consists of **witnessing a process** or procedure being performed by others. For **example**, the auditor may observe the counting of inventories being performed by client's personnel.
d. Inquiry and Confirmation – **"Inquiry"** consists of seeking appropriate information from knowledgeable persons inside or outside the entity. **"Confirmation"** consists of the response to an inquiry. For **example**, the auditor requests confirmation of receivables by

direct communication with debtors.
e. Recalculation - Recalculation consists of **checking the mathematical accuracy** of documents or records. Recalculation may be performed manually or electronically.
f. Analytical Procedures - Analytical Procedures refers to **studying significant ratios** and trends and investigating unusual fluctuations.
g. Reperformance - Reperformance involves auditor's independent **execution of procedures** or controls that were originally performed as part of entity's internal control.

ii) Information to be used as Audit Evidence –
a. When designing and performing audit procedures, the auditor shall consider the **relevance and reliability** of the information to be used as audit evidence.
b. The **reliability** of audit evidence is **increased** when it is obtained from independent sources outside the entity.
c. The reliability of audit evidence that is **generated internally** is increased when the related **controls are effective**. Audit evidence **obtained directly** by the auditor is **more reliable** than audit evidence obtained indirectly.
d. Audit evidence in **documentary form**, whether paper, electronic, or other medium, is **more reliable** than evidence obtained orally.
e. Audit evidence provided by **original documents** is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitised or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.
f. When information to be used as audit evidence has been prepared using the work of a **management's expert**, the auditor shall:
• **Evaluate** the **competence**, capabilities and objectivity of that expert;
• Obtain an **understanding of the work** of that expert; and
• **Evaluate appropriateness** of that expert's work as audit evidence for relevant assertion.
g. When using information **produced by the entity**, the auditor shall **evaluate** whether the information is sufficiently **reliable** for the auditor's purposes.

iii) Selecting Items for Testing to Obtain Audit Evidence - When designing tests of controls and tests of details, the auditor shall determine **means of selecting items for testing** that are **effective** in meeting the purpose of the audit procedure.

iv) Inconsistency in, or Doubts over Reliability of Audit Evidence - If,
a. audit evidence obtained from one source is **inconsistent** with that from another;
b. Auditor has **doubts over the reliability** of information to be used as audit evidence.
Auditor shall **determine what modifications** to audit procedures are **necessary** to resolve the matter, and shall consider **effect** of matter, if any on other aspects of the audit.

SA 501 - AUDIT EVIDENCE - SPECIFIC CONSIDERATIONS FOR SELECTED ITEMS

A. Objective - To obtain sufficient appropriate audit evidence regarding the:
i) Existence and condition of inventory
ii) Completeness of litigation and claims involving the entity; and
iii) Presentation & disclosure of segment information in accordance with applicable FRF.

B. Requirements -
i) Inventory -
a. Sufficient Appropriate Evidence - When inventory is material, he shall obtain sufficient appropriate **evidence w.r.t. existence and condition** of inventory by attendance at physical count & examining entities final inventory records & comparing them

with actual count result evaluate IC, Observe management, count procedure, Inspect inventory, and Perform test count.
b. Inventory Counting Conducted At Date Other Than B/S Date - He shall perform **additional procedure w.r.t. changes** in inventory between count date & B/S date.
c. Auditor Unable To Attend Inventory Count Due To Unforeseen Circumstances - He shall make some **count on alternate date** and perform procedures on intervening transactions.
d. Attendance At Inventory Count Is Impracticable - He shall perform **alternate procedures.** If it is not possible, then **modify the audit report**.
e. Inventory Under Control Of A Third Party - Obtain evidences by performing one or more of following:
- Request **confirmation** from third party.
- Obtaining **service auditor's report** w.r.t. adequacy of procedures of third party.
- Attending / arranging **another auditor** to attend third party's counting procedure.
- **Inspecting documentation** (Example - warehouse receipts).
- **Request confirmation** from parties when inventory has been pledged as collateral.

ii) Litigation and Claims
a. Identify Litigation and Claims - Perform procedures to Identify litigation & claims by **Inquiring management** & others. **Reviewing minutes** of meetings of TCWG and correspondence with **legal counsel** & reviewing legal expense account.
b. Risk Of Misstatement w.r.t Litigation & Claims - If Risk is identified then, seek communication with **entity's external legal counsel**. If law, regulation etc. prohibits such direct communication & then perform **alternate procedures**.
c. Written Representation (WR) - Auditor shall request WR from management and TCWG that **all know litigation** & claims affecting FS have been **disclosed to auditor** and appropriately accounted for.
d. Modify the opinion – If management does **not permit auditor to communicate with legal counsel** or Legal counsel **refuses** to respond and auditor is unable to obtain sufficient appropriate evidence then modify opinion.

iii) Segment Information
a. Sufficient Appropriate Evidences - w.r.t. presentation and disclosure of segment information as per applicable FRF
b. Audit procedures - He should **understand the methods used** by management and evaluate their consistency with applicable FRF. perform **analytical procedures** appropriate in circumstances.

SA 505 - EXTERNAL CONFIRMATIONS

A. Objective - The objective of the auditor, when using external confirmation procedures, is to design and perform such procedures to obtain relevant and reliable audit evidence.

B. Definitions
i) External Confirmation - Audit evidence obtained as a direct written response to the auditor from a third party in paper form, or by electronic or other medium.
ii) Positive Confirmation Request - A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing requested information.
iii) Negative Confirmation Request - A request that the confirming party respond directly to the auditor only if confirming party disagrees with the information provided in the request.
iv) Exception - A response that indicates a difference between information requested to be

confirmed, or contained in the entity's records, and information provided by the confirming party.

C. Requirements -
i) External Confirmation Procedures - He shall maintain control over external conformation requests including following:
a. Determining the information to be confirmed,
b. Selecting the appropriate third party,
c. Designing the confirmation requests (Properly addressed also),
d. Sending the request including follow-up requests if required.

ii) Management Refusal to Allow The Auditor To Send A Confirmation Request
In such case, he shall
a. Inquire management's **reasons** for refusal and assess their validity,
b. Evaluate the possibility of **risk** of material misstatement and
c. Perform **alternative procedures**.
If the auditor concludes that:
a. If management's refusal is **unreasonable**, or
b. Auditor is **unable to perform** alternate procedures.
Then he shall **communicate** with TCWG and consider **effect** on his report.

iii) Results of the External Confirmation Procedures
a. Reliability Of Response to Confirmation Requests - If he has doubts about reliability of response, he shall obtain **further evidences** to resolve doubts. If response is found to be **unreliable**, it may indicate fraud risk factor. He shall consider its **effect** on Nature, Timing and Extent of other procedures.
b. Non Responses - In the case of each non-response, the auditor shall perform **alternative audit procedures** to obtain relevant and reliable audit evidence.
c. When a Response to a Positive Confirmation Request is Necessary to Obtain Sufficient Appropriate Audit Evidence - If the auditor has determined that a response to a positive confirmation request is necessary to obtain sufficient appropriate audit evidence, alternative audit procedures will not provide the audit evidence the auditor requires. If the auditor does **not obtain such confirmation**, the auditor shall determine the **implications** for the audit and the auditor's **opinion** in accordance with **SA 705**
d. Exceptions - The auditor shall **investigate** exceptions to determine whether or not they are indicative of misstatements.

iv) Negative Confirmation Requests - It asks the third party to respond directly to the auditor only if there is disagreement with the information provided in the request. It is considered to be less persuasive than the positive confirmation request. Auditor should **use** them **only if all of following are present**:
a. Risk of misstatement is **low**
b. IC is effective
c. Item contains **small amount**
d. Low exception rate is expected
e. No reason to believe that recipient may disregard the request.

v) Evaluating the Evidence Obtained - The auditor shall **evaluate** whether the **results** of the external confirmation procedures provide **relevant and reliable audit evidence**, or whether performing **further audit procedures** is necessary.

SA 510 - INITIAL AUDIT ENGAGEMENTS- OPENING BALANCES

A. Objective - In conducting an initial audit engagement, objective of auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:
i) Opening balances contain misstatements that materially affect the current period's FSs;
ii) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's FSs, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable FRF.

B. Definition –
i) Initial Audit Engagement - An engagement in which either:
a. The FSs for the prior period were **not audited**; or
b. The FSs for the prior period were **audited by a predecessor auditor**.

C. Requirements –
i) Audit Procedures –
a. Opening Balances - The auditor shall **read the most recent FSs**, if any, and the predecessor **auditor's report** thereon, if any, for information relevant to opening balances, including disclosures. The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances **contain misstatements** that materially affect the current period's FSs by:
• Determining whether the prior period's closing balances have been **correctly brought forward** to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;
• Determining whether the opening balances reflect the application of appropriate **accounting policies**; and
• Performing one or more of the following:
~ Where the prior year FSs were audited, perusing the **copies of the audited FSs**.
~ Evaluating whether audit **procedures** performed in the current period provide evidence relevant to the opening balances; or
~ Performing **specific audit procedures** to obtain evidence regarding opening balances.
If the auditor obtains audit evidence that the opening balances contain misstatements that could **materially affect** the current period's FSs, the auditor shall perform such **additional audit procedures** as are appropriate in the circumstances to determine the effect on the current period's FSs. If the auditor concludes that such misstatements exist in the current period's FSs, the auditor shall **communicate the misstatements** with the appropriate level of management and those charged with governance in accordance with **SA 450**.
b. Consistency of Accounting Policies - The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been **consistently applied** in the current period's FSs, and whether **changes** in the **accounting policies** have been properly accounted for and adequately presented and **disclosed** in accordance with the applicable FRF.
c. Relevant Information in the Predecessor Auditor's Report - If the prior period's FS were audited by a predecessor auditor and there was a **modification to the opinion**, the auditor shall **evaluate the effect** of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's FSs in accordance with SA 315.

ii) Audit Conclusions and Reporting
a. Opening Balances - • If the auditor is **unable to obtain sufficient appropriate audit evidence** regarding the opening balances, the auditor shall express a **qualified opinion or a disclaimer of opinion.** • If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's FSs, and the effect of the misstatement is not properly accounted for or not adequately presented or disclosed, the

auditor shall express a **qualified opinion or an adverse opinion.**
b. Consistency of Accounting Policies - If the auditor concludes that the current period's accounting policies are **not consistently applied** in relation to opening balances in accordance with the applicable FRF. A **change in accounting policies** is not properly accounted for or not adequately presented or disclosed in accordance with the applicable FRF. The auditor shall express a **qualified opinion or an adverse opinion**.
c. Modification to the Opinion in the Predecessor Auditor's Report - If the predecessor auditor's opinion regarding the prior period's FSs included a modification to the auditor's opinion that **remains relevant and material** to the **current period's FSs,** the auditor shall **modify** the auditor's opinion on the current period's FSs.

SA 520 - ANALYTICAL PROCEDURES

A. Objective - The objectives of the auditor are:
i) To obtain relevant & reliable audit evidence when using substantive analytical procedures; and
ii) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the FS are consistent with the auditors understanding of the entity.

B. Analytical Procedures - It means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.
Nature of Analytical Procedures - It includes **comparison with:**
i) Comparable information for **prior periods**.
ii) Anticipated results like budgets or forecasts.
iii) Similar **industry** information.
iv) Predictive estimates prepared by the auditor.

C. Requirements -
i) Substantive Analytical Procedures (SAP) - When using substantive analytical procedures, he shall consider the **following four factors:**
a. Suitability of Particular SAP - He should **determine suitability** of SAP for a particular item. These are generally adopted for those transactions that tend to be predictable over time for **example**, it can be used to compare gross profit ratio in a stable entity. However, such comparisons may not be performed for PSU.
b. Reliability Of Data To Be Compared - It is influenced by the following:
- **Source** of information available (more reliable if obtained from some independent source)
- **Comparability** of information available (Entities should be comparable)
- **Relevance** of the information available (budgets should be realistic)
- **Control** over Preparation of information (if last year's FS are audited)

c. Development of Expectations - He shall develop an expectation of recorded values. Their expectations should be sufficiently **precise** so that misstatement can be identified.
d. Difference of Recorded Amount from Expected Values That Is Acceptable - SA 330 requires auditor to **obtain more persuasive evidence** if he identifies high risk. Thus, for risky items, acceptable differences should be low. If difference is more than acceptable difference, he shall **further investigate** to rule out the possibility of misstatement.

ii) Analytical Procedures That Assist When Forming Overall Conclusion - He shall design and perform analytical procedures **near the end of audit**. This way he can conclude whether FS are **consistent with his understanding** of entity. Thus, it helps him in forming opinion on FS.

iii) Investigating Results of Analytical Procedures - If he identifies **fluctuations** or a significant difference between recorded & expected values, he shall **investigate by inquiring of management** and thereafter **obtaining evidences** to corroborate the same, & performing other procedures as necessary in the circumstances.

SA 530 - AUDIT SAMPLING

A. Objective - The objective of the auditor when using audit sampling is to provide a reasonable basis for the auditor to draw conclusion about the population from which the sample is selected.

B. Definitions -
i) Audit Sampling (Sampling) - The application of audit procedures to **less than 100% of items** within a population such that all sampling units have a chance of selection in order to draw conclusions about the entire population.
ii) Population - The **entire set of data** from which a sample is selected and about which the auditor wishes to draw conclusions.
iii) Sampling Risk - The **risk that the auditor's conclusion** based on a sample may be **different** from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to **two types of erroneous conclusions**:
a. in the case of a test of controls, that controls are **more effective** than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
b. In the case of a test of controls, that controls are **less effective** than they actually arc, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.
iv) Non-Sampling Risk - The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.
v) Anomaly - A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.
vi) Sampling Unit - The individual items constituting a population.
vii) Statistical Sampling - An approach to sampling that has the following characteristics:
a. Random selection of the sample items; and
b. The **use of probability theory** to evaluate sample results, including measurement of sampling risk. A sampling approach that does not have characteristics (a) or (b) is considered non-statistical sampling
viii) Stratification - The **process of dividing** a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).
ix) Tolerable Misstatement - A **monetary amount set** by the auditor in respect of which the auditor seeks to obtain an **appropriate level of assurance** that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.
x) Tolerable Rate of Deviation - A **rate of deviation** from prescribed IC procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

C. Requirements –
i) Sample Design, Size and Selection of Items for Testing - The auditor shall **determine a sample size** sufficient to reduce sampling risk to an acceptably low level. The auditor shall select items for the sample in such a way that each sampling unit in the

population has a chance of selection.

ii) Performing Audit Procedures - The auditor shall perform audit procedures, appropriate to the purpose, on each item selected. If the auditor is **unable to apply** the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall **treat that item as a deviation or a misstatement**.

iii) Nature and Cause of Deviations and Misstatements - The auditor shall **investigate** the **nature and cause** of any deviations or misstatements identified, and **evaluate**s their possible **effect** in the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population.

iv) Projecting Misstatements - For tests of details, the auditor shall project misstatements found in the sample to the population.

v) Evaluating Results of Audit Sampling - The auditor shall evaluate the results of the sample and whether the use of audit sampling has provided a **reasonable basis** for conclusions about the **population** that has been **tested**.

D. Examples of Factors Influencing Sample Size For Test of Control -

FACTOR	EFFECT ON SAMPLE SIZE
An increase in number of sampling units in the population	Negligible effect
An increase in the extent to which the auditor's risk assessment taken into account relevant controls	Increases
An increase in tolerable rate of deviation	Decreases
An increase in expected rate of deviation of the population to be tested	Increases

E. Examples of Factors Influencing Sample Size For Test of Details -

FACTOR	EFFECT ON SAMPLE SIZE
An increase in tolerable mis-statement	Decreases
An increase in amount of mis-statement, the auditor expects to find in the population	Increases
An increase in auditor's assessment of risk of material mis-statement	Increases
Stratification of the population when appropriate	Decreases
An increase in the use of other substantive procedures directed at the same assertion	Decreases

F. Sample Selection Method - There are many methods of selecting samples. The principle method are as follows-
i) Random Selection (applied through random number generators. e.g., random numbers.
ii) Systematic Selection - in which the number of **sampling units** in the population is **divided by the sample size** to give a sampling interval, for e.g. 50 and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number table.
iii) Monetary Units Sampling - monetary unit sampling is a type of value weighted selection in which sample size, selection and evaluation results in a conclusion in **monetary amounts.**

iv) Haphazard selection - in which the auditor selects the sample without following a structured technique. Although **no structured technique** is used the auditor would none the less avoid any conscious, bias or predictability and thus attempt to ensure that all items in the population have a chance of selection is not appropriate when using statistical sampling.
v) Block Selection – It involves selection of a **block of contiguous items** from within the population. It **cannot ordinarily be used** in audit sampling because most population are structured such that items in a sequence can be expected to have similar characteristics to each other, but **different characteristics** from items elsewhere in the population.

SA 540 – AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, & RELATED DISCLOSURES

A. Objectives - To obtain sufficient appropriate audit evidence whether accounting estimates, including fair value accounting estimates are reasonable; and related disclosures in the FS are adequate.

B. Definitions -
i) Accounting Estimate - An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty.
ii) Auditor's Point Estimate or Auditor's Range - The amount, respectively, derived from audit evidence for use in evaluating management's point estimate.
iii) Estimation Uncertainty - The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.
iv) Management Bias - A lack of neutrality by management.
v) Management's Point Estimate - The amount selected by management for recognition or disclosure in the FSs as an accounting estimate.
vi) Outcome of an Accounting Estimate - The actual monetary amount which results from the resolution of the underlying transaction(s) and event(s).

C. Nature of Accounting Estimates - Some FS items cannot be measured precisely, but can **only be estimated**. For purposes of this SA, such FS items are referred to as accounting estimates. The degree of estimation uncertainty affects the risks of material misstatement of accounting estimates. A difference between the outcome of an accounting estimate and the amount originally recognized in the FSs does **not necessarily** represent a **misstatement** of the FSs. This is particularly the **case for fair value accounting estimates**.

D. Requirements –
i) Risk Assessment Procedures and Related Activities - Auditor shall obtain an understanding of the following in order to identify and assess the risks of material misstatement for accounting estimates:
a. The **requirements** of the applicable financial reporting framework.
b. How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates.
c. How management makes **accounting estimates** (methods, assumptions, use of expert)
d. Auditor shall **review** the outcome of accounting estimates included in the prior period FS.

ii) Identifying and Assessing the Risks of Material Misstatement - In identifying and assessing risks of material misstatement, as required by SA 315, auditor shall **evaluate** the **degree of estimation uncertainty** associated with an accounting estimate. The auditor

shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having **high estimation uncertainty** give rise to significant risks.

iii) Responses to the Assessed Risks of Material Misstatements - Based on the assessed risks of material misstatement, the auditor shall determine:
a. Whether management has **appropriately applied** the applicable FRF.
b. Whether the **methods are appropriate** and have been applied **consistently**,

iv) Further Substantive Procedures to Respond to Significant Risks -
a. Estimation Uncertainty - For accounting estimates that give rise to significant risks, the auditor shall **evaluate** the following:
• **How management** has considered alternative assumptions or outcomes, and why it has rejected them.
• Whether the **significant assumptions** used by management are reasonable.
• If, in the **auditor's judgment**, management has not adequately addressed the effects of estimation uncertainty, the auditor shall **evaluate** the reasonableness of accounting estimate.
b. Recognition and Measurement Criteria - For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence whether the following are in accordance with the requirements of the applicable financial reporting framework:
• **Management's decision** to recognise/not recognise, the accounting estimates in the FS;
• The **selected measurement basis** for the accounting estimates.

v) Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements - The auditor shall **evaluate**, based on the audit evidence, whether the accounting estimates in the FS are either **reasonable** in the context of the applicable financial reporting framework, or are misstated.

vi) Disclosures Related to Accounting Estimates - The auditor shall **obtain** sufficient appropriate audit **evidence** about whether the accounting estimates and their disclosure in the FSs is appropriate. For accounting estimates that give rise to significant risks, the auditor shall **check adequacy of the disclosure** of their estimation uncertainly in the FSs.

vii) Indicators of Possible Management Bias - The auditor shall **review** the judgments and decisions made by management.

viii) Written Representations - The auditor shall **obtain** written representations from management whether management **believes significant assumptions** used by it in making accounting estimates are reasonable.

ix) Documentation - The audit documentation shall include:
a. The **basis** for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and
b. **Indicators** of possible **management bias**, if any.

SA 550 - RELATED PARTIES

A. Objective - The objectives of the auditor are:
i) Irrespective of whether the applicable Financial Reporting Framework (FRF.) establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:
a. To **recognise fraud risk factors**, if any, arising fresh related party relationships and

transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
b. To **conclude** whether the **FS,** insofar as they are **affected by those relationships** and transactions achieve a true and fair presentation; or are not misleading; and
ii) In addition, where the applicable FRF. establishes related party requirements, to obtain sufficient appropriate audit evidence about whether **related party relationships** and **transactions** have been appropriately **identified, accounted for and disclosed** in the FS in accordance with the framework.

B. Definitions –
i) Arm's Length Transaction - A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.
ii) Related Party – A party that is either:
a. A related party as defined in the **applicable FRF**., or
b. Where the applicable FRF. establishes minimal or no related party requirements:
• A **person** or other **entity** that has **control or significant influence**, directly or indirectly through one or more intermediaries, over the reporting entity;
• **Another entity** over which the reporting entity has **control or significant influence**, directly or indirectly through one or more intermediaries; or
• **Another entity** that is under **common control** with the reporting entity through having:
~ Common controlling ownership;
~ Owners who are close family members; or
~ Common key management.
However, entities that are under common control by a state (i.e., a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another

C. Nature of Related Party Relationships and Transactions -
i) The nature of related party, relationships and transactions may, in some circumstances, **give rise to higher risks** of **material misstatement** of the FS than transactions with unrelated parties. **For example** - Related party transactions may not be conducted under normal market terms and conditions; Some related party transactions may be conducted with no exchange of consideration.
ii) Planning and performing the audit with professional skepticism is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions.
iii) The requirements in this SA are designed to **assist the auditor in identifying and assessing the risks of material misstatemen**t associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

D. Requirements -
i) Risk Assessment Procedures and Related Activities –
a. Understanding the Entity's Related Party Relationships and Transactions - The auditor shall **inquire** of management regarding:
• The **identity** of the entity's related parties, including changes from the prior period;
• The **nature of the relationships** between the entity and these related parties; and
• Whether the entity entered into any **transactions** with these related parties during the period and, if so, the type and purpose of the transactions.
The auditor shall **inquire of management and others** within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to:

~ **Identify**, account for, and **disclose related party relationships and transactions** in accordance with the applicable FRF.;
~ **Authorise and approve** significant transactions and arrangements **with related parties**; and
~ Authorize and approve significant transactions and arrangements **outside the normal course** of business.

b. Maintaining Alertness for Related Party Information When Reviewing Records or Documents - During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may **indicate the existence of related party relationships or transactions** that management has not previously identified or disclosed to the auditor. If the auditor identifies significant transactions outside the entity's normal course of business the auditor shall inquire of management about:
• The **nature** of these transactions; and
• Whether **related parties** could be involved.

c. Sharing Related Party Information with the Engagement Team - The auditor shall share relevant information obtained about the entity's related parties with the other members of the engagement team.

ii) Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions - The auditor shall identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are **significant risks**. If the auditor identifies **fraud risk factors** the auditor shall consider such information when identifying and assessing the risks of material misstatement due to fraud in accordance with SA 240.

iii) Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions –

a. Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions - If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:
• Promptly **communicate** the relevant information to other members of engagement team;
• Where the **applicable FRF.** establishes related party requirements:
~ Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and
~ Inquire as **to why** the entity's controls over related party relationships and transactions **failed** to enable the identification or disclosure of the related party relationships or transactions;
• Perform appropriate **substantive audit procedures** relating to such newly identified related parties or significant related party transactions;
• **Reconsider** the **risk that other related parties** or significant related party transactions may **exist** that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary; and
• If **non-disclosure** by management appears **intentional** evaluate implications for audit.

b. Identified Significant Related Party Transactions outside the Entity's Normal Course of Business - For identified significant related party transactions outside the entity's normal course of business, the auditor shall:
• **Inspect** the underlying contracts or agreements, if any, and **evaluat**e whether:
~ The **business rationale** (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;
~ The **terms of the transactions** are consistent with management's explanations; and
~ The transactions have been **appropriately accounted** for and **disclosed** in accordance

with the applicable FRF; and
• **Obtain audit evidence** that transactions have been appropriately authorised & approved.
c. Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm's Length Transaction - When management has made an assertion in the FS to the effect that a related party transaction was conducted on terms equivalent to those prevailing in an **arm's length transaction**, the auditor shall obtain **sufficient appropriate audit evidence** about the assertion.

iv) Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions - In forming an opinion on the FS auditor shall evaluate:
a. Whether the identified related party relationships and transactions have been **appropriately accounted** for and **disclosed** in accordance with the applicable FRF.; and
b. Whether **the effects** of the related party relationships and transactions:
• **Prevent the FS** from achieving true and fair presentation; or
• **Cause** the FS to be **misleading.**
Where the applicable FRF establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance (TCWG).

v) Written Representations
a. They have **disclosed to the auditor** the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and
b. They have **appropriately accounted** for and disclosed such relationships and transactions in accordance with the requirements of the framework.

vi) Communication with TCWG - Unless all of TCWG are involved in managing the entity, the auditor shall communicate with TCWG **significant matters** arising during the audit in connection with the entity's related parties.

vii) Documentation - In meeting the documentation requirements of SA 230 and other SAs, the auditor shall include in the audit documentation the **names** of the identified related parties and the **nature of the related party relationships**.

SA 560 - SUBSEQUENT EVENTS

A. Objective - The objectives of the auditor are to:
i) Obtain sufficient appropriate audit evidence about whether events occurring between the date of the FS and the date of the auditor's report that require adjustment of, or disclosure in, the FS are appropriately reflected in those FS; and
ii) Respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

B. Definitions -
i) Date of the FS - The date of the end of the latest period covered by the FS.
ii) Date of approval of the FS - The date on which the FS have been prepared & those with the recognized authority have asserted that they have taken responsibility for those FS.
iii) Date of the auditor's report - The date the auditor dates the report on the FS.
iv) Date the FS are issued - The date that the auditor's report and audited FS are made available to third parties.
v) Subsequent events - Events occurring between the date of FS and the date of auditor's

report, and facts that become known to the auditor after the date of the auditor's report.

C. Requirements -
i) Events Occurring Between the Date of the FS and the Date of the Auditor's Report - The auditor shall obtain sufficient appropriate audit evidence that all events occurring between the date of the FS and the date of the auditor's report that require **adjustment** of, or **disclosure** in, the FS have been **identified.**
The auditor shall:
a. Obtain an understanding of any procedures management has established to ensure that subsequent events are identified.
b. Inquiring of management and TCWG.
c. Read minutes, if any, of the meetings, of the entity's owners, management and TCWG, that have been held after the date of the FS.
d. Read the entity's **latest subsequent interim FS**, if any. If auditor identifies events that require adjustment of, or disclosure in, the FS, the auditor shall determine whether each such event is appropriately reflected in those FS.
Written Representations - Auditor shall request management to provide **Management Representation Letter** that **all** events occurring subsequent to the date of FS & for which the applicable FRF. requires adjustment or disclosure have been **adjusted or disclosed.**

ii) Facts which become known to the Auditor after the Date of the Auditor's Report but Before the Date the FS are Issued - The auditor has no obligation to perform any audit procedures regarding the FS after the date of the auditor's report. However, when, after the date of the auditor's report but before the date the FS are issued, a **fact becomes known to the auditor** that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:
a. Discuss the matter with management and TCWG
b. Determine whether the FS need **amendment** and, if so,
c. Inquire how management intends to **address the matter** in the FS. If management **amends the FS**, the auditor shall:
• **Extend the audit procedures** referred to the date of the new auditor's report; and
• Provide a **new auditor's report** on the amended FS.
When law, regulation or the FRF does not prohibit management from restricting the amendment of the FS to the effects of the subsequent events, the auditor is permitted, to restrict the audit procedures on subsequent events to that amendment.
In such cases, the auditor shall either:
a. Amend the auditor's report to include an additional date restricted to that amendment; **or b.** Provide a **new or amended auditor's report** that includes a statement in an **Emphasis of Matter paragraph or Other Matter(s) paragraph** that conveys that auditor's procedures on subsequent events are restricted solely to the amendment of the FS as described in the relevant note to the FS. In some entities, management may not be required by the applicable law, regulation or the FRF. to issue amended FS and, accordingly, the auditor need not provide an amended or new auditor's report. However, when management does **not amend** the FS in circumstances where the auditor believes they **need to be amended**, then
a. If auditor's report has not yet been provided to entity, He shall **modify** the **opinion**; **or**
b. If auditor's report has **already** been **provided** to entity, He shall **notify** management & TCWG **not to issue** the FS to third parties before necessary amendments have been made. If the FS are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate **action**, to seek to prevent reliance on the auditor's report.

iii) Facts which become known to the Auditor after the FS have been issued - After the FS has been issued, the auditor has **no obligation** to perform any audit procedures

regarding such FS. However, when, after the FS have been issued, a fact becomes known to the auditor that, had it been **known** to the auditor **at the date of the auditor's report**, may have caused the auditor to **amend** the auditor's report, the auditor shall:
a. Discuss the matter with management and TCWG
b. Determine whether the **FS need amendment** and, if so,
c. Inquire how management intends to address the matter in the FS. If the management amends the FS, the auditor shall:
• **Carry out the audit procedures** necessary in the circumstances on the amendment.
• **Review** the steps taken by management to ensure that anyone in receipt of the previously issued FS together with the auditor's report thereon is informed of the situation. If management does not take the necessary steps to ensure that anyone in receipt of the previously issued FS is informed of the situation, the auditor will seek to prevent future reliance on the auditor's report.

SA 570 - GOING CONCERN

A. Objective - The objectives of the auditor are:
i) To obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the FS;
ii) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
iii) To determine the implications for the auditor's report.

B. Going Concern Assumption - Under the going concern assumption, an entity **is viewed as continuing** in business for the **foreseeable future**. General purpose FS are prepared on a going concern basis, unless management either **intends to liquidate** the entity or to **cease operations**. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

C. Responsibilities Of Management -
i) In case the FS have not been prepared on a going concern basis, the **fact** would need to be appropriately disclosed.
ii) The **detailed requirements** regarding management's responsibility may also be set out in the **law** or regulation.
iii) It is the management's responsibility to **assess the entity's ability to continue** as a going concern even if the FRF does not include an explicit requirement to do so. The **following factors** are relevant to that judgment:
a. The **degree of uncertainty** associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs.
b. The **size and complexity of the entity**, the **nature and condition of its business** and the degree to which it is affected by external factors.
c. Any judgment about the future is based on information available at the time at which the judgment is made. However subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

D. Responsibilities of Auditor - The auditor's responsibility is to **obtain** sufficient appropriate **audit evidence** about the appropriateness of management's use of the going concern assumption. He shall consider whether there is a **material uncertainty** about the entity's ability to continue as a going concern. The absence of any reference to going

concern uncertainty in an auditor's report **cannot be viewed as a guarantee** as to the entity's ability to continue as a going concern. (SA 200A)

E. <u>Requirements</u> -

<u>i) Risk Assessment Procedures And Related Activities</u> - The auditor shall consider whether there are events or conditions that may **cast significant doubt** on the entity's ability to continue as a going concern. In so doing, the auditor shall determine whether management has already performed a **preliminary assessment** of the entity's ability to continue as a going concern (discuss with management). If such an assessment has not performed, that auditor shall **discuss with management** the basis for the intended use of going concern assumption & inquire of management whether events or conditions exist that, individually or collectively, may east significant doubt on the entity's to continue as a going concern. The auditor shall **remain alert throughout the audit** for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. There may be following types of indicators:

Financial Indicators	Negative Net worth/working capital;
	Arrears / discontinuance of Dividends;
	Adverse Financial ratio;
	Substantial operating losses;
	Borrowings approaching maturity without any chance of renewal/repayment;
	Short term borrowing for long term asset financing;
	No payment to creditors on due date.
	Non compliance with terms in loan agreement;
	Negative cash flow from operations;
	Rearrangement with creditors for reduction in liability; or
	Change from creditors to cash on delivery transaction with supplier.
Operating Indicators	Loss of key management and no replacement available;
	Loss of major market or supplier;
	Labour unrest, strikes etc; or
	Loss of major license, franchise, etc.
Other Indicators	Pending legal proceedings;
	Change in Govt. Policy affecting the entity adversely; or
	Non- compliance with Statutory requirements

However, such indications may be mitigated by some positive factors .For example:
loss of some major supplier may be compensated by availability of some alternate source of supply.

<u>ii) Evaluating Management's Assessment</u> - In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor **shall cover the same period** as that used by management to make its assessment as required by law or regulation if it specific a longer period. In evaluating management's assessment, the auditor shall **consider whether** management has considered all **relevant information** of which the auditor is aware.

<u>iii) Period Beyond Management's Assessment</u> - The auditor shall **inquire** of **management** as to its knowledge of **events or conditions** beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern.

iv) Additional Audit Procedures When Events or Conditions Are Identified - When events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall **perform procedures** as follows:
a. Request management to make its assessment of the **entity's ability** to continue as a going concern. When management has not yet performed an assessment of entity's ability to continue as a Going Concern
b. Evaluating management's **plans** for future actions.
c. When the entity has prepared a **cash flow forecast**, and then considers its reliability.
d. Considering whether any **additional facts or information** have become available since the date on which management made its assessment.
e. Requesting written representations from management or TCWG, regarding their plans for **future action** and the **feasibility** of these plans.

v) Audit Conclusions and Reporting - Auditor shall conclude whether a **material uncertainty exists** related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material **uncertainty exists** when the magnitude of its **potential impact** and likelihood of occurrence is such that, in the auditor's judgment, appropriate **disclosure** of the nature and implications of the uncertainly is **necessary**.

vi) Use of Going Concern Assumption Appropriate but a Material Uncertainty Exists - When the auditor concludes that use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the FS:
a. **Adequately describe** the principal **events or conditions** that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and
b. **Disclose clearly** that there is a **material uncertainty** related to events or conditions that may **cast significant doubt** on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

If adequate **disclosure is made** in the FSs, the auditor shall express an **unmodified opinion** and include an **Emphasis of Matter paragraph** in the auditor's report to:
a. Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and to
b. Draw attention to the **note** in the FS that discloses the matters set out.

If adequate **disclosure is not made**, auditor shall express **qualified or adverse opinion,** as appropriate. Auditor shall state in the auditor's report that there is a material uncertainty that may cast significant doubt about entity's ability to continue as going concern.

vii) Use of Going Concern Assumption Inappropriate - If FS have been prepared on a going concern basis but, in the auditor's judgment, management's use of the going concern **assumption** in the FS is **inappropriate**, the auditor shall express an **adverse opinion**.

viii) Management Unwilling to Make or Extend Its Assessment - If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor shall **consider the implications** for the auditor's report.

ix) Communication with TCWG - Communication with TCWG shall include the following:
a. Whether the events or conditions constitute a **material uncertainty**;
b. Whether the **use of the going concern assumption** is **appropriate** in the preparation and presentation of the FS; and

c. The **adequacy** of related **disclosures** in the FS.

x) Significant Delay in Approval of FS - When the auditor believes that the delay in the approval of the FS could be related to events or conditions relating to the going concern assessment, the auditor shall perform **additional audit procedures** necessary.

SA 580 - WRITTEN REPRESENTATIONS

A. Objective - The objectives of auditor are:
i) To obtain written representations from management that management believes that it has fulfilled the fundamental responsibilities.
ii) To support other audit evidence by means of written representations, if determined necessary by the auditor or required by other SM; and
iii) To respond appropriately to written representations provided by management or absence thereof.

B. Written Representations as Audit Evidence - Similar to responses to inquiries, written representations are audit evidence. Although written representations provide necessary audit evidence, they **do not provide sufficient appropriate audit evidence on their own** about any of the matters with which they deal. Furthermore, the **fact** that management has provided reliable written representations **does not affect the nature or extent of other audit evidence** that the auditor obtains.

C. Written Representations - A written statement **by management** provided to the auditor **to confirm certain matters** or to support other audit evidence. Written representations in this context do not include FS, the assertions therein or supporting books and records.
From Whom - The auditor shall request written representations from management with **appropriate responsibilities** for the FS and **knowledge of the matters** concerned.

D. Requirements -
i) Management from Whom Written Representations Requested - The auditor shall request written representations from management with appropriate responsibilities for the FS and knowledge of the matters concerned.

ii) Written Representations about Management's Responsibilities -
a. Preparation and Presentation of the FS - written representation that mgt. has fulfilled its responsibility for the preparation and presentation of the FS
b. Information Provided to the Auditor - Written representation that mgt. has provided the auditor with all relevant information agreed in the terms of the audit engagement and that all transactions have been recorded and are reflected in the FS.

iii) Other Written Representations - Other SAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations, the auditor shall request such other written representations.

iv) Date of and Period(s) Covered by Written Representations - The date of the written representations shall be as **near** as practicable **to**, but not after, the **date of the auditor's report** on the FS. The written representations shall be for all FS and period(s) referred to in the auditor's report.

v) Form of Written Representations - The written representations shall be in the form of a representation letter **addressed** to the **auditor**. If law or regulation requires management to make written public statements about its responsibilities, the relevant matters covered by such statements need not be included in the representation letter.

vi) Doubt as to the Reliability of Written Representations and Requested Written Representations Not Provided -

a. Doubt as to the Reliability of Written Representations - If the auditor has concerns about the competence, integrity, ethical values or diligence of management, the auditor shall **determine** their **effect on the reliability of representations** (oral or written) and audit evidence in general. In particular, if written representations are **inconsistent** with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the auditor concludes that the written representations are **not reliable**, the auditor shall take appropriate actions, including determining the possible effect on the opinion.

b. Requested Written Representations Not Provided - if management does not provide one or more of the requested representation, he shall **discuss** the matter with management and **re-evaluate** the reliability and integrity of management. He shall consider its **effect on his audit report** as well.

c. Written Representation about Management's Responsibilities - The auditor shall **disclaim an opinion** on the FS if:

• The auditor concludes that there is sufficient **doubt about the integrity** of management such that the written representations are not reliable; or

• Management does **not provide the written representations**.

SA 600 - USING THE WORK OF ANOTHER AUDITOR

A. Objective - When the auditor delegates the work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on financial information.

B. Definitions -

i) Another Auditor – Another Auditor does **not mean internal auditor**. It means the auditor of a component (branch/subsidiary) of the organisation.

ii) Principal Auditor - Auditor of client.

iii) Component - Any branch, division, subsidiary, joint venture or associates etc, whose financial information is used in the FS of client.

C. Acceptance as Principal Auditor - The auditor should consider whether the auditor's own participation is sufficient to be able to act as a Principal auditor. For this purpose the auditor would consider:

i) The **materiality** of the portion of the financial information which the principal auditor audits.

ii) The principal auditor's **degree of knowledge** regarding the business of the components.

iii) The **risk of material mis-statements** in the financial information of the component audited by the other auditor; and

iv) The **performance of additional procedures** as set out in this SA regarding the components audited by other auditor resulting in the principal auditor having significant participation in such audit.

D. <u>The Principal Auditor's Procedure</u> –
i) When planning to use the work of another auditor, the principal auditor should consider the **professional competence** of the other auditor in the context of specific assignment if the other auditor is not a member of the ICAI.
ii) The principal auditor should **perform procedures** to obtain sufficient appropriate audit evidence, that the **work** of the other auditor is **adequate** for the principal auditor's purposes, in the context of specific assignments. When using the work of another auditor, the principal auditor ordinarily **perform** the **following procedures**.
a. Advice the other auditor of the **use** that is to be made of the other auditor's work and report.
b. Advice the other auditor of the significant accounting, auditing and **reporting requirements.**
c. Principal auditor may require another auditor to **submit questionnaire** w.r.t. work performed by him.
d. The principal auditor should consider the **significant findings** of the other auditor.
iii) The principal auditor should **document** in his working papers the **components** whose financial information was audited by another auditor.

E. <u>Co-Ordination Between Auditors</u> - There should be **sufficient liaison** between the principal auditor and the other auditor. For this purpose, the principal auditor may find it necessary to issue **written communications** to the other auditor.
The other auditor, knowing the context in which his work is to be used by the principal auditor, should **co-ordinate** with the principal auditor. **For example**, by bringing to the principal auditor's immediate attention any **significant findings** requiring to be dealt with at entity level, adhering to the **time table** for audit of the component, etc. he should ensure compliance with the relevant **statutory requirements.** Similarly, the principal auditor should **advice the other auditor** of any matters that come to his attention that he thinks may have an important bearing on the other auditor's work.

F. <u>Reporting Considerations</u> - When the principal auditor concludes, based on his procedures, that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient **additional procedures** regarding the financial information of the component audited by the other auditor, the principal auditor should express a **Qualified opinion or Disclaimer of opinion** because there is a limitation on the scope of audit.

G. <u>Division of Responsibility</u> - When the principal auditor has to base his opinion on the financial information of the entity as a whole relying upon the statements and reports of the other auditor, his **report** should **state clearly** the division of responsibility for the financial information an opinion of the entity **by indicating** the extent to which the financial information of components **audited by other auditor** have been included in the financial information of the entity. **Example** - The number of divisions' branches/subsidiaries or other components audited by other auditors.

It is not necessary that principal auditor will qualify his report if other auditors who have audited the components have given any qualified report.

SA 610 - USING THE WORK OF INTERNAL AUDITORS

A. Objectives - The objectives of the external auditor, where the entity has an internal audit function that the external auditor has determined is likely to be relevant to the audit, are to determine:
i) Whether, and to what extent, to use specific work of the internal auditors; and
ii) If so, whether such work is adequate for the purposes of the audit.

B. Definitions –
i) Internal Audit Function - An appraisal activity established or provided as a service to the entity. Its functions include, amongst other things, examining, the adequacy and effectiveness of internal control.
ii) Internal Auditors - Those individuals who perform the activities of the internal audit function. Internal auditors may belong to an internal audit department or equivalent function.

C. Relationship between the Internal Audit Function and the External Auditor - The **role and objectives** of the internal audit function are **determined by management** and, where applicable, TCWG. While the **objectives** of the internal audit function and the external auditor are **different**, **some** of the **ways** in which the internal audit function and the external auditor achieve their respective **objectives may be similar**. Irrespective of the degree of autonomy and objectivity of the internal audit function, such function is **not independent** of the entity as is required of the external auditor when expressing an opinion on FS. The **external auditor has sole responsibility** for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of internal auditors.

D. Requirements –
i) Determining Whether and to What Extent to Use the Work of the Internal Auditors - The external auditor shall determine:
a. Whether the **work** of internal auditors is likely to be **adequate** for purposes of the audit;
b. If so, the **planned effect of the work** of the internal auditors on the nature, timing or extent of the external auditor's procedures.

In determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, the external auditor shall **evaluate**:
a. The **objectivity** of the internal audit function;
b. The **technical competence** of the internal auditors;
c. Whether the **work** of the internal auditors is **carried out with due professional care**; and
d. Whether there is **effective communication** between internal and the external auditor.

In determining the planned effect of the work of the internal auditors on the nature, timing or extent of the external auditor's procedures, the external auditor shall consider:
a. The **nature and scope** of specific work performed/to be performed, by internal auditors;
b. The **assessed risks** of material misstatement at the assertion level for particular classes of transactions, account balances, and disclosures; and
c. The **degree of subjectivity** involved in the evaluation of the audit evidence gathered by the internal auditors in support of the relevant assertions.

ii) Using Specific Work of the Internal Auditors -
a. In order for the external auditor to use specific work of the internal auditors, the external auditor shall **evaluate and perform audit procedures** on that work to determine its

adequacy for the external auditor's purposes.
b. To determine the **adequacy of specific work performed** by the internal auditors for the external auditor's purposes, the external auditor shall **evaluate** whether:
• Work was performed by internal auditors having adequate **technical training** & proficiency;
• The work was properly **supervised, reviewed** and documented;
• **Adequate audit evidence** has been obtained to enable him to draw reasonable conclusions;
• **Conclusions** reached are **appropriate** in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed and
• Any **exceptions/unusual matters disclosed** by the internal auditors are properly **resolved.**

iii) Documentation - The external auditor shall **document conclusions** regarding the evaluation of the adequacy of the work of the internal auditors, and the audit procedures performed by the external auditor on that work.

SA 620 - USING THE WORK OF AN EXPERT

A. Objectives – The objectives of auditor are to determine whether:
i) To use the work of auditor's expert &
ii) That work is adequate for his purpose.

B. Definitions –
i) Auditor's Expert - An individual / organization possessing expertise in a field **other than accounting or auditing** whose work is used by auditor in obtaining evidence. He may be auditor's internal expert or external expert.
ii) Management Expert - Whose work is used by Entity in preparing the FS.

SA not applicable when –
i) Engagement team includes a member, who is expert in area of accounting/auditing,
ii) Auditor's use of management's expert.

C. Auditor's Responsibility -
i) Auditor has **sole responsibility** of his audit opinion.
ii) His responsibility is **not reduced** by using auditor's expert.
iii) However, he may accept the work of auditor's expert as evidence if he concludes that auditor's expert is **adequate**.

D. Requirements –
i) Determining the Need for Auditor's Expert - If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall **determine whether to use** the work of an auditor's **expert**.

ii) Nature, Timing and Extent of Audit Procedures - The nature, timing and extent of the auditor's procedures with respect to the requirements of this SA will vary depending on the circumstances. In determining the nature, timing and extent of those procedures, the auditor shall consider matters including:
a. The **nature** of the matter to which that expert's work relates;
b. The **risks** of material misstatement in the matter to which that expert's work relates;
c. The **significanc**e of that expert's work in the context of the audit;
d. The **auditor's knowledge** of and experience with previous work performed by expert;

e. Whether that expert is subject to auditor's firm's **quality control policies & procedures**.

iii) The Competence, Capability and Objectivity of Auditor's Expert's - The auditor shall evaluate whether the auditor's expert has the **necessary competence, capabilities and objectivity** for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding **interests and relationships** that may create a threat to that expert's objectivity.

iv) Obtaining The Understanding The Field Of Expertise Of Auditor's Expert - The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to:
a. Determine the **nature, scope and objectives** of that expert's work for auditor's purposes;
b. Evaluate the **adequacy** of that work for the auditor's purposes.

v) Agreement with Auditor's Expert - The auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert:
a. The **nature, scope and objectives** of that expert's work;
b. The **respective roles** and responsibilities of the auditor and that expert;
c. The **nature, timing and extent of communication** between the auditor and that expert, including the form of any report to be provided by that expert; and
d. The **need** for the auditor's expert to observe confidentiality requirements.

vi) Evaluating Adequacy Of Auditor's Expert's Work - The auditor shall **evaluate** the adequacy of the auditor's expert's work for the auditor's purposes, including:
a. The **relevance and reasonableness** of that expert's **findings or conclusions**, and their **consistency** with other audit evidence;
b. If that expert's work involves **use of significant assumptions and methods**, the relevance and reasonableness of those assumptions and methods in the circumstances; and
c. If that expert's work involves the **use of source data** that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.

vii) Reference To Auditor's Expert In Auditor's Report -
a. In case of unmodified opinion - Auditor shall **not refer to work** of auditor's expert in the **report** containing unmodified opinion **unless required by law / regulations** to do so. If required by law/regulations, he shall indicate in auditor's report that such reference does not reduce auditor's responsibility for the audit opinion.
b. In case of modified opinion - He shall **refer to work of auditor's expert** if such reference is **necessary for understanding** the nature of modification. He shall indicate that such reference does not reduce auditor's responsibility for the audit opinion.

General Clarification (GC)–AASB/1/2002 ON SA 620, Using the Work of an Expert
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

SA 700 - FORMING AN OPINION AND REPORTING ON FS

A. Objectives –
i) From an opinion on the FS based on an evaluation of the conclusions drawn from audit evidence obtained and
ii) Express clearly that opinion through a written report that also describes the basis for the opinion.

B. General Purpose Framework - This Financial Reporting Framework (FRF) meets the common financial information needs of many users. It may be of **two types:**
i) Fair Presentation Framework - FRF that requires compliance with the requirements of FRF and acknowledges that **Management may provide disclosures beyond those specifically required by the framework**. Management **may depart** from requirements of framework to achieve **fair presentation** of FS. **Example**: FS of a company.
ii) Compliance Framework - FRF requiring compliance with requirements of the framework but does not contain acknowledgement as above.

C. Requirements –
i) Forming an Opinion on the FS –
a. Auditor shall from an opinion as to whether the FS are prepared in accordance with applicable FRF.
b. To from such an opinion, he shall obtain reasonable assurance as to whether FS as a whole are free from material misstatements.
c. In forming such opinion he shall **consider the following**:
• **Sufficiency & appropriateness** of audit evidences,
• **Materiality** of uncorrected misstatements,
• Adequacy of **disclosures** in FS,
• Consistency of **accounting Policies** with applicable FRF,
• Reasonableness of **Accounting Estimates,**
• Reliability & relevance of financial information,
• Adequacy of **disclosur**e of material transactions & Events,
• Appropriateness of **Terminology** used in FS.
d. In case of **fair presentation framework**, he shall also consider:
• **Overall presentation**, structure and content of the FS, &
• Whether FS represent the underlying transactions & events to **achieve** fair presentation.

ii) Form of Opinion -
a. Unmodified Opinion - When he concludes that FS are prepared, in all material respects, in accordance with applicable FRF.
b. Modified Opinion - When the auditor:
• Concludes that FS as a whole are **not free** from material misstatements, or
• is **unable to obtain sufficient and appropriate evidence** to conclude that the FS as a whole are free from material misstatement.

iii) Auditor's Report - Auditor's report for audits conducted in accordance with SA's has following **basic elements**:
a. Title - Clearly indicating that it is an "**Independent Auditor's Report**", So that it can be distinguished from the reports issued by others.
b. Addressee - The auditor's report shall be addressed as required by the **circumstances** of the engagement.
c. Introductory Paragraph - The introductory paragraph in the auditor's report shall:
• **Identify the entity** whose FS have been audited;
• State that the FS have been **audited**;

• **Identify the title** of each statement that comprises the FS;
• **Refer** to the summary of **accounting policies** and other explanatory information;
• **Specify the date** or period **covered** by each FS comprising the FS.

d. Management's Responsibility for the FS - It describes the responsibility of Management / TCWG who are responsible for preparation of FS. It states that management is responsible for:
• **Preparation of FS** as per applicable FRF;
• Design, implementation & maintenance of **internal controls**; &
• **Fair presentation** of FS (in case, FS are prepared as per fair presentation framework)

e. Auditor's Responsibility - This Para shall state that:
• Responsibility of auditor is to **express an opinion** on the FS;
• Audit was conducted in accordance with **SA** issued by ICAI;
• Auditor complied with **ethical requirements**;
• Auditor obtained assurance as to whether FS are **free from material misstatements**;
• Audit involves procedures to obtain evidences about amounts & disclosures in FS;
• Procedures depend on the **auditor's judgment** including RAP;
• Auditor considers **internal controls** but do not express opinion thereon.
• Audit includes **evaluation of accounting policies** & overall presentation of FS; and
• Auditor believes that audit evidences are sufficient to provide basis for auditor's report.

f. Auditor's Opinion - While expressing unmodified opinion he shall use following:
• **In Case of Fair Presentation Framework** – FS present fairly in accordance with [Applicable FRF]. FS give true & fair view in accordance with [Applicable FRF]
• **In Case of Compliance Framework** - FS are prepared in all material respects in accordance with [applicable FRF]

g. Other Reporting Responsibilities - If there is any requirement, there shall be a separate heading "Report on other legal and Regulatory Requirements".
For Example - CARO in case of audit of a company.

h. Date of Auditor's Report - It can't be earlier that the date on which:
• All components of FS have been prepared, &
• Management/TCWG have asserted that they have taken the responsibility for those FS.

i. Place of Signature - Specific location (The city where the audit report is signed)

j. Signature of the Auditor –
• **In Case Of Sole Practitioner** - It is signed in the **personal name** of auditor. Mention **membership no.** of member in ICAI as well.
• **In Case Of Firm** - it is signed in **personal name** of proprietor/Partner **as well as in the name of firm**. **Firm's registration** no. is also mentioned in this case.

iv) Supplementary Information Presented With FS - Auditor shall **evaluate** whether it is clearly differentiated from the audited FS. If not, then he shall **ask the management to change the way** it is presented. If management **refuses** to do so, the auditor shall **mention is the audit report that such supplementary information has not been audited**.

SA 705 - MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

A. Types of Modified Opinions - This SA establishes three types of modified opinions, namely, a **qualified opinion**, an **adverse opinion**, and a **disclaimer of opinion**.
The **decision** regarding which type of modified opinion is appropriate **depends upon:**
i) The **nature of the matter** giving rise to the modification, that is, whether the FS are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

ii) The **auditor's judgment** about the pervasiveness of the effects or **possible effects of the matter** on the FS.

	Material but Not Pervasive	**Material and Pervasive**
FS are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

After Accepting the Engagement, If Management Imposes Limitations, He shall request the Management to Remove the Same

↓

<table>
<tr><th colspan="4">If Management</th></tr>
<tr><th>Removes The Same</th><th colspan="3">Refuses To Remove The Same</th></tr>
<tr><td>OK</td><td colspan="3">Communicate to TCWG</td></tr>
<tr><td rowspan="6">Continue</td><td colspan="3">Whether it is possible to perform alternate procedures to obtain sufficient appropriate evidences</td></tr>
<tr><td>Yes</td><td colspan="2">No</td></tr>
<tr><td rowspan="5">Ok</td><td colspan="2">If Possible Effect on FS</td></tr>
<tr><td>Material But Not Pervasive</td><td>Material And Pervasive</td></tr>
<tr><td colspan="2">Qualified Opinion Determine Possibility Of Resignation</td></tr>
<tr><td>Yes</td><td>No</td></tr>
<tr><td>Resign</td><td>Communicate to TCWG + Disclaimer</td></tr>
</table>

B. <u>Requirements</u> -

i) Circumstances When a Modification to the Auditor's Opinion Is Required - The auditor shall **modify the opinion** in the auditor's report when the auditor:

a. Concludes, based on the evidences obtained that the FS as a whole are not free from material misstatements, or

b. Is **unable to obtain** sufficient and appropriate **evidences** to conclude that FS as a whole are free from material misstatements.

<u>ii) Determining the Type of Modification to the Auditor's Opinion</u>

<u>a. Qualified Opinion</u> - The auditor shall express a qualified opinion when:

• The auditor, having **obtained sufficient appropriate** audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the FS;

• The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the **possible effects** on the FS **of undetected misstatements,** if any, could be **material but not pervasive**.

<u>b. Adverse Opinion</u> - The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are **both material and pervasive** to the FS.

<u>c. Disclaimer of Opinion</u> - The auditor shall disclaim an opinion when the auditor is **unable to obtain sufficient appropriate audit evidence** on which to base the opinion, and the auditor concludes that the possible effects on the FS of undetected misstatements, if any, could be both **material and pervasive**.

The auditor shall **disclaim an opinion** when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the FS due to the potential interaction of the uncertainties and their possible cumulative effect on the FS.

Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management - Imposed Limitation after the Auditor Has Accepted the Engagement - If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a **qualified opinion or to disclaim an opinion** on the FS, the auditor shall request management to **remove the limitation**.
If management **refuses to remove** the limitation, the auditor shall **communicate the matter to those charged with governance** and determine whether it is possible to **perform alternative procedures** to obtain sufficient appropriate audit evidence.
If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows:
a. If the auditor concludes that the possible effects on the FS of undetected misstatements, if any, could be **material but not pervasive**, the auditor shall **qualify the opinion**; or
b. If the auditor concludes that the possible effects on the FS of undetected misstatements, if any, could be **both material and pervasive** so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall:
• **Resign** from the audit, where practicable and not prohibited by law or regulation; or
• If resignation from the audit before issuing the auditor's report is not practicable or possible, **disclaim an opinion** on the FS.
If the auditor resigns, **before resigning,** the auditor shall **communicate** to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

Other Considerations Relating to an Adverse Opinion or Disclaimer of Opinion - When the auditor considers it necessary to express an adverse opinion or disclaim an opinion on the FS as a whole, the auditor's report **shall not also include an unmodified opinion** with respect to the same financial reporting framework **on a single FS or one or more specific elements**, accounts or items of a FS. To include such an unmodified opinion in the same report in these circumstances would **contradict** the auditor's adverse opinion or disclaimer of opinion on the FS as a whole.

iii) Form & Content Of Auditor's Report In Case Of Modified Opinion
a. Basis for Modification Paragraph - He shall, in addition to SA 700, place this Para immediately before the opinion Para. Its **heading** is "Basis for _____ opinion" as appropriate. Here, he shall **describe the matter** giving rise to modification. It includes **quantification of financial effects** of matter unless impracticable. If **not practicable** to quantify, **state this fact**.
b. Basis for Qualified Opinion - Except for the effects of matter described in the "Basis for qualified opinion" Para,
• The FS present fairly, in all material respects (or give a true & fair view) in accordance with fair presentation framework, or
• The FS have been prepared in all respects, in accordance with compliance framework.
c. Basis for Adverse Opinion - In the auditor's opinion because of significance of matters described in the basis for adverse opinion Para:
• The FS do **not present fairly** (or give a true & fair view) in accordance with the fair presentation framework; or
• The FS have **not been prepared**, in accordance with compliance **framework.**"
d. Basis for Disclaimer of Opinion - Because of significance of the matter described in the "basis for disclaimer" Para, the auditor has not been able to obtain sufficient appropriate evidence & thus, the auditor does not express an opinion on the FS.
e. Description of Auditor's Responsibility:
• **In case of Qualified/Adverse Opinion** - State that auditor has **obtained** sufficient & appropriate evidences to provide a **basis for Auditor's modified opinion**

• **In case of Disclaimer of Opinion** - State that auditor has **obtained not able to obtain** sufficient & appropriate evidences and **a basis for such opinion**

iv) Communication with Those Charged with Governance - In case he expects to **modify his opinion**, He shall **communicate** the circumstances & proposed wordings.

SA 706 - EMPHASIS OF MATTER PARAGRAPHS & OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT

A. Objective - The objective of the auditor, having formed an opinion on the FS, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:
i) A **matter**, although appropriately presented or disclosed in the FS, that is of such **importance** that it is **fundamental** to users' understanding of the FS; or
ii) As appropriate, **any other matter** that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

B. Requirements –
i) Emphasis of Matter Paragraph
a. Meaning - Para which refers to a matter appropriately incorporated in the FS, which is of such importance that it is fundamental to user's understanding of FS.
b. In Audit Report - Place it immediately after the opinion paragraph in auditor's report.
c. Heading - "Emphasis of matter"
d. It Includes - Clear reference to the matter being emphasised; and where exactly it can be found in the FS.
e. Clarification by Auditor - That audit opinion is not modified in respect of the matter emphasised
f. Examples where Emphasis of Matter may be necessary:
• Substantial doubt about going concern properly disclosed in FS.
• Material change in the accounting policy.
• Early application of a new accounting standard.
• Uncertainty relating to a pending litigation, properly disclosed in the FS by management.

ii) Other Matter Paragraph
a. Meaning - Para relating to matter, Other than those in FS, which is relevant to, User's understanding or auditor's responsibility or his report.
b. In audit report - After the "Opinion" Para & any "Emphasis of matter" Para
c. Heading – "Other Matter"
d. Examples where it is necessary
• Other reporting responsibilities in case of audit of a company
• LFAR in case of audit of a bank.

iii) Communication with TCWG - If auditor expects to include an Emphasis of matter or other matter paragraph, he shall communicate the same to TCWG

SA 710 - COMPARATIVE INFORMATION - CORRESPONDING FIGURES & COMPARATIVE FINANCIAL STATEMENTS

A. Objectives -
i) To obtain sufficient appropriate audit evidence about whether the comparative information included in the FS has been presented in all material respects, in accordance with the requirements for comparative information in the applicable FRF; and

ii) To report in accordance with the auditor's reporting responsibilities.

B. Nature Of Comparative Information - The nature of comparative information that is presented in an entity's FS depends on the **requirements of the applicable FRF**. There are **two different broad approaches** to auditor's reporting responsibilities in respect of such comparative information; corresponding figures & comparative FS. The approach to be adopted is **specified by law/regulation** but may be specified in **terms of engagement**.

C. Definitions -

i) Comparative Information - The **amounts and disclosures** included in FS in respect of one or more **prior periods** in accordance with the applicable **reporting framework**.

ii) Corresponding Figures - Comparative information where amounts and other disclosures for the prior period are included as an **integral part** of the **current period** FS, and are intended to be read only in relation to the current period. The level of detail presented in the corresponding amounts and disclosures is dictated primarily by, its relevance to the current period figures.

iii) Comparative FS - Comparative information where amounts and other disclosures for the prior period are included for comparison with the FS of current period but, if audited, are referred to in auditor's opinion. The level of FS is comparable with FS of current period. For purposes of this SA references to prior period should be read as **"prior periods"** when the comparative information includes amounts & disclosures for more than one period.

D. The Essential Audit Reporting Difference Between The Approaches Are:

i) for **corresponding** figures, auditor's opinion on FS refers to **current period only**,

ii) for **comparative FS**, auditor's opinion refers to **each period** for which FS are presented

E. Requirements -

i) Audit Procedures -

a. Determine as to Whether - FS include Comparative information required by FRF, & such information is classified appropriately.

b. Evaluate Whether - Comparative information agrees with the amounts and other disclosures presented in the prior period; and Accounting policies reflected in the comparative information are **consistent** with those applied in the current period. **Changes** in accounting policies, if any, have been properly accounted for and disclosed.

c. Professional Skepticism - In case there is a doubt of Material Misstatement in comparative information; He shall perform **additional audit procedures** to obtain sufficient appropriate audit evidence regarding existence of material misstatement.

d. Obtain Written Representation - For all periods referred to in his opinion Also, for any prior period item **separately disclosed** in current year's profit and loss statement

ii) Audit Reporting

a. Corresponding Figures - When corresponding figures are presented, the auditor's opinion shall **not refer to the corresponding figures except in the circumstances** described below ***, **, ***.**

If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is **unresolved**, the auditor shall **modify** the auditor's opinion on the current period's FS. In the **Basis for Modification paragraph** in the auditor's report, the auditor shall either:

• **Refer to both** the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the **effects** or possible effects of the matter on the **current period's** figures are **material; or**

• In **other cases**, explain that the audit **opinion** has been **modified** because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

***** If the auditor obtains audit evidence that a material misstatement exists in the prior period FS on which an unmodified opinion has been previously issued, the auditor shall verify whether the **misstatement** has been **dealt with as required** under the applicable financial reporting framework and, if that is not the case, the auditor shall express a **qualified opinion or an adverse opinion** in the auditor's report on the current period FS, modified with respect to the corresponding figures included therein.

**** Prior Period FS Audited by a Predecessor Auditor -** If the FS of the prior period were audited by a predecessor auditor and the auditor is permitted by law or regulation to refer to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor **shall state** in an **Other Matter paragraph** in the auditor's report:
• That the FS of the prior period were **audited by the predecessor** auditor;
• The **type of opinion** expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and
• The **date** of that report.

***** Prior Period FS Not Audited -** If the prior period FS were not audited, the auditor shall state in an **Other Matter paragraph** in the auditor's report that the corresponding figures are unaudited. Such a statement does **not relieve** the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's FS

b. Comparative FS - When comparative FS are presented, the auditor's opinion shall refer to each period for which FS are presented and on which an audit opinion is expressed. When reporting on prior period FS in connection with the current period's audit, if the auditor's opinion on such prior period FS **differs** from the **opinion** the auditor **previously expressed**, the auditor shall **disclose the substantive reasons** for the different opinion in an Other Matter paragraph in accordance with SA 706

Prior Period FS Audited by a Predecessor Auditor - If the FS of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's FS, the auditor shall state in an Other Matter paragraph:
• That the FS of the prior period were **audited** by a predecessor auditor;
• The **type of opinion** expressed by the predecessor auditor and, if the opinion was modified, the **reasons** therefore; and
• The **date** of that report, unless the predecessor auditor's report on the prior period's FS is revised with the FS.
If the auditor concludes that a material misstatement exists that affects the prior period FS on which the predecessor auditor had previously reported without modification, the auditor shall communicate the misstatement with the appropriate level of management and those charged with governance and request that the predecessor auditor be informed. If the prior period FS are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended FS of the prior period, the auditor shall report only on the current period.
Prior Period FS Not Audited - If the prior period FS were not audited, the auditor shall state in an Other Matter paragraph that the comparative FS are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's FS.

SA 720 - THE AUDITOR'S RESPONSIBILITY IN RELATION TO OTHER INFORMATION IN DOCUMENTS CONTAINING AUDITED FS

A. Objective - The objective of the auditor is to respond appropriately when documents containing audited FS and the auditor's report thereon include other information that could undermine the credibility of those FS and the auditor's report.

B. Definitions -
i) Other Information - **Financial and non-financial information** which is included, either by law, regulation or custom, in a document containing audited FS & auditor's report thereon.
ii) Inconsistency - Other information that **contradicts** info contained in the audited FS.
iii) Misstatement of Fact - Other information that is **unrelated** to matters appearing in the audited FS that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited FS.

C. Requirements -
i) Reading Other Information - The auditor shall:
a. Read other information **to identify material inconsistencies** with the audited FS.
b. Make **appropriate arrangements with management** or those charged with governance to obtain the other information prior to the date of the auditor's report

ii) Material Inconsistencies - If on reading the other information, the auditor identifies a material inconsistency; the auditor shall determine whether the **audited FS** or the other information needs to be **revised.**
a. Material Inconsistencies Identified in Other Information Obtained Prior to the Date of the Auditor's Report –
• When **revision** of the audited FS is necessary and management refuses to make the revision, the auditor shall **modify the opinion**.
• When **revision** of the other information is necessary and management refuses to make the revision, the auditor shall **communicate** this matter to those charged with governance; and

- ✓ Include in the auditor's report an **Other Matter(s) paragraph** describing the material inconsistency.
- ✓ Where **withdrawal** is legally permitted, withdraw from the engagement.

b. Material Inconsistencies Identified in Other Information Obtained Subsequent to the Date of the Auditor's Report –
• "When **revision** of the **audited FS** is necessary, the auditor shall follow the relevant requirements in SA 560 (Revised).
• When **revision** of the **other information** is necessary and **management agrees** to make the revision, the auditor shall carry out the procedures necessary under the circumstances.
• When **revision** of the **other information** is necessary, but **management refuses** to make the revision, the auditor shall notify those charged with governance of the auditor's concern regarding the other information and take any further appropriate action.

iii) Material Misstatements of Fact – When the auditor:
a. On reading the other information for the purpose of identifying material inconsistencies, becomes aware of a material misstatement, He shall **discuss the matter with management**.
b. Still considers that there is an apparent material misstatement of fact, He shall request management to **consult with a qualified third party** & shall consider the advice received.

c. Concludes that there is a material misstatement of fact in the other information which management refuses to correct, the auditor shall **notify TCWG** of the auditor's concern regarding the other information and **take any further appropriate action**.

SA 800 - SPECIAL CONSIDERATIONS - AUDITS OF FS PREPARED IN ACCORDANCE WITH SPECIAL PURPOSE FRAMEWORKS

A. Objective - The objective of the auditor, when applying SAs in an audit of FS prepared in accordance with a special purpose framework, is to address appropriately the special considerations that are relevant to:
i) The acceptance of the engagement;
ii) The planning and performance of that engagement; and
iii) Forming an opinion and reporting on the FS.

B. Definitions -
i) Special Purpose FS – FS prepared in accordance with a special purpose framework.
ii) Special purpose framework – A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a **fair presentation framework or a compliance framework.**

C. Requirements -
i) Considerations When Accepting the Engagement
Acceptability of the Financial Reporting Framework - SA 210 (Revised) requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the FS. In an audit of special purpose FS, the auditor shall obtain an understanding of:
a. The **purpose** for which the FS are prepared;
b. The **intended users**; and
c. The **steps taken by management** to determine that the applicable financial reporting **framework** is acceptable in the circumstances.

ii) Considerations When Planning and Performing the Audit - SA 200 (Revised) requires the auditor to **comply with all SAs relevant** to the audit. In planning and performing an audit of special purpose FS, the auditor shall determine whether application of the SAs requires special consideration in the circumstances of the engagement.
SA 315 requires the auditor to obtain an understanding of the entity's **selection and application of accounting policies**. In the case of FS prepared in accordance with the provisions of a contract, the auditor shall obtain an understanding of any **significant interpretations** of the contract that management made in the preparation of those FS. An interpretation is significant when adoption of another reasonable interpretation would have produced a **material difference** in the information presented in the FS.

iii) Forming an Opinion and Reporting Considerations - When forming an opinion and reporting on special purpose FS, the auditor shall apply the requirements in SA 700.
a. Description of the Applicable Financial Reporting Framework - SA 700 (Revised) requires the auditor to **evaluate** whether the FS **adequately refer** to or describe the applicable financial reporting framework. In the case of FS prepared in accordance with the provisions of a contract, the auditor shall evaluate whether the FS adequately describe any significant interpretations of the contract on which the FS are based.
SA 700 (Revised) deals with the **form and content** of the auditor's report. In the case of an auditor's report on special purpose FS:
• The auditor's report shall also **describe the purpose** for which the FS are prepared and, if necessary, refer to a note in the special purpose FS that contains that information; and

• If management has a **choice of financial reporting frameworks** in the preparation of such FS, the explanation of management's responsibility for the FS shall also make reference to its responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

b. Alerting Readers that the FS Are Prepared in Accordance with a Special Purpose Framework - The auditor's report on special purpose FS shall include an **Emphasis of Matter paragraph** alerting users of the auditor's report that the FS are prepared in accordance with a special purpose framework and that, as a result, the FS may not be suitable for another purpose. The auditor shall include this paragraph under an appropriate heading.

SA 805 - SPECIAL CONSIDERATIONS - AUDITS OF SINGLE FS AND SPECIFIC ELEMENTS, ACCOUNTS OR ITEMS OF A FINANCIAL STATEMENT

A. Objective - The objective of the auditor is to address appropriately the special considerations that are relevant to:
i) The acceptance of the engagement;
ii) The planning and performance of that engagement; and
iii) Forming an opinion and reporting on the single FS or on the specific element, account or item of a FS.

B. Definitions -
i) Element of a FS or element - means an "element, account or item of a FS";
ii) Financial Reporting Standards - means the Accounting Standards promulgated by the Accounting Standards Board (ASB) of the ICAI or Accounting Standards, notified by the Central Government by publishing the same as the Companies (Accounting Standards) Rules, 2006, or the Accounting Standards for Local Bodies promulgated by the Committee on Accounting Standards for Local Bodies (CASLB) of the ICAI, as may be applicable; and
A single FS (for example, a cash flow statement) or to a specific element of a FS (for example, cash and bank balances) **includes the related notes.** The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the FS or to the element.

C. Requirements -
i) Considerations When Accepting the Engagement
a. Application of SAs - SA 200 (Revised) requires the auditor to comply with **all SAs** relevant to the audit. In the case of an audit of a **single FS** or of a **specific element** of a FS, this requirement applies irrespective of whether the auditor is also engaged to audit the entity's complete set of FS. If the auditor is not also engaged to audit the entity's complete set of FS, the auditor shall determine whether the audit of a single FS or of a specific element of those FS in accordance with SAs is practicable.
b. Acceptability of the Financial Reporting Framework - SA 210 (Revised) requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the FS. In the case of an audit of a single FS or of a specific element of a FS, this shall include whether application of the financial reporting framework will **result** in a presentation that provides **adequate disclosures** to enable the intended users to understand the information conveyed in the FS or the element, and the **effect of material transactions** and events on the information conveyed in the FS or the element.
c. Form of Opinion - SA 210 (Revised) requires that the agreed terms of the audit engagement include the **expected form** of any reports to be issued by the auditor. In the case of an audit of a single FS or of a specific element of a FS, the auditor shall consider whether the **expected form of opinion is appropriate** in the circumstances.

ii) Considerations When Planning and Performing the Audit - SA 200 (Revised) states that SAs are written in the context of an audit of FS; they are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.

iii) Forming an Opinion and Reporting Considerations - When forming an opinion and reporting on a single FS or on a specific element of a FS, the auditor shall **apply** the requirements in **SA 700**, adapted as necessary in the circumstances of the engagement.

Reporting on the Entity's Complete Set of FS and on a Single FS or on a Specific Element of Those FS - If the auditor undertakes an engagement to report on a single FS or on a specific element of a FS in conjunction with an engagement to audit the entity's complete set of FS, the auditor shall **express a separate opinion** for each engagement. An audited single FS or an audited specific element of a FS may be **published** together with the entity's audited complete set of FS. If the auditor concludes that the presentation of the single FS or of the specific element of a FS does **not differentiate it sufficiently** from the complete set of FS, the auditor shall **ask management to rectify** the situation. The auditor shall also differentiate the opinion on the single FS or on the specific element of a FS from the opinion on the complete set of FS. The auditor shall **not issue the auditor's report** containing the opinion on the single FS or on the specific element of a FS **until satisfied** with the **differentiation**.

Modified Opinion, Emphasis of Matter Paragraph or Other Matter Paragraph in the Auditor's Report on the Entity's Complete Set of FS - If the opinion in the auditor's report on an entity's complete set of FS is modified, or that report includes an **Emphasis of Matter paragraph** or an Other Matter paragraph, the auditor shall determine the **effect** that this may have on the auditor's report on a single FS or on a specific element of those FS. When deemed appropriate, the auditor shall **modify the opinion** on the single FS or on the specific element of a FS, **or** include an **Emphasis of Matter paragraph** or an **Other Matter paragraph** in the auditor's report, accordingly.
If the auditor concludes that it is necessary to express an **adverse** opinion or **disclaim** an opinion on the entity's complete set of FS as a whole, SA 705 does not permit the auditor to include in the same auditor's report an unmodified opinion on a single FS that forms part of those FS or on a specific element that forms part of those FS. This is because such an unmodified opinion would **contradict** the adverse opinion or disclaimer of opinion on the entity's complete set of FS as a whole.
If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of FS as a whole but, in the context of a separate audit of a specific element that is included in those FS, the auditor nevertheless considers it appropriate to express an **unmodified opinion on that element**, he shall only **do so if:**
a. The auditor is **not prohibited by law** or regulation from doing so;
b. That opinion is expressed in an auditor's report that is **not published together** with the auditor's report containing the adverse opinion or disclaimer of opinion; and
c. Specific element does **not constitute a major portion** of entity's complete set of FS.
The auditor shall **not express** an **unmodified opinion** on a single FS of a complete set of FS if the auditor has expressed an adverse opinion or disclaimed an opinion on the complete set of FS as a whole. This is the case even if the auditor's report on the single FS is not published together with the auditor's report containing the adverse opinion or disclaimer of opinion. This is because a single FS is deemed to constitute a major portion of those FS.

SA 810 - ENGAGEMENTS TO REPORT ON SUMMARY FS

A. Objectives - The objectives of the auditor are to:
i) Determine whether it is appropriate to accept the engagement to report on summary FS;
ii) Form an opinion on the summary FS based on an evaluation of the conclusions drawn from the evidence obtained; and
iii) Express clearly that opinion through a written report that also describes the basis for that opinion.

B. Definitions -
i) Applied Criteria – The criteria applied by management in preparation of summary FS.
ii) Audited FS – FS audited by the auditor in accordance with SAs, and from which the summary FS are derived.
iii) Summary FS – Historical financial information that is derived from FS but that contains less detail than the FS, while still providing a structured representation consistent with that provided by the FS of the entity's economic resources or obligations at a point in time or the changes therein for a period of time.

C. Requirements -
i) Engagement Acceptance - The auditor shall, ordinarily, accept an engagement to report on summary FS in accordance with this SA only when the auditor has been engaged to conduct an audit in accordance with SAs of the FS from which the summary FS are derived. Before accepting an engagement to report on summary FS, the auditor shall:
a. Determine whether the **applied criteria** are acceptable;
b. Obtain the **agreement of management** that it acknowledges and understands its responsibility:

- For the **preparation of the summary FS** in accordance with the applied criteria;
- To make the **audited FS available to the intended users** of the summary FS without undue difficulty; and
- To **include the auditor's report** on the summary FS in any document that contains the summary FS and that indicates that the auditor has reported on them.

c. Agree with management the **form of opinion** to be expressed on the summary FS.

If the auditor concludes that the **applied criteria** are **unacceptable** or is **unable to obtain** the **agreement** of management, he shall not accept the engagement to report on the summary FS, unless required by law or regulation to do so. The auditor shall include appropriate **reference** to this fact in the terms of the engagement. The auditor shall also **determine** the effect that this may have on the engagement to audit the FS from which the summary FS are derived.

ii) Nature of Procedures - The auditor shall perform the **following procedures**, and any other procedures that the auditor may consider necessary, as the basis for the auditor's opinion on the summary FS:
a. Evaluate whether the summary FS adequately **disclose** their summarised nature and identify the audited FS.
b. When summary FS are **not accompanied by the audited FS, evaluate** whether they describe clearly:

- From whom or where the audited FS are available; or
- The law or regulation that specifies that the audited FS need not be made available to the intended users of the summary FS and establishes the criteria for the preparation of the summary FS.

c. Evaluate whether the summary FS adequately **disclose** the applied criteria.

d. Compare the summary FS with the information in the audited FS to determine whether the summary FS agree with information in the audited FS.
e. Evaluate whether the summary FS are prepared in accordance with the **applied criteria**.
f. Evaluate, in view of the purpose of the summary FS, whether the summary FS **contain the information necessary,** and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.
g. Evaluate whether the audited FS are **available to the intended users** of the summary FS without undue difficulty, unless law or regulation provides that they need not be made available and establishes the criteria for the preparation of the summary FS.

iii) Form of Opinion - When the auditor has concluded that an **unmodified opinion** on the summary FS is appropriate, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following **phrases:**
a. The summary FS are **consistent**, in all respects, with the audited FS; or
b. The summary FS are a **fair summary** of the audited FS.

If law or **regulation prescribes** the **wording of the opinion** on summary FS in terms that are **different** from those described in paragraph, the auditor shall:
a. Apply the procedures described in paragraph & any **further procedures** necessary to enable the auditor to express the prescribed opinion; and
b. Evaluate whether users of the summary FS might misunderstand the auditor's opinion on the summary FS and, if so, whether **additional explanation** in the auditor's report on the summary FS can mitigate possible misunderstanding. Accordingly, the auditor's report on the summary FS shall not indicate that the engagement was conducted in accordance with this SA.

iv) Timing of Work and Events Subsequent to the Date of the Auditor's Report on the Audited FS - The auditor's report on the summary FS may be **dated later than the date of the auditor's report** on the audited FS. In such cases, the auditor's report on the summary FS shall state that the summary FS and audited FS **do not reflect the effects of events** that occurred subsequent to the date of the auditor's report on the audited FS that may require adjustment of, or disclosure in, the audited FS.
The auditor may become **aware of facts that existed at the date of the auditor's report** on the audited FS, but of which the auditor previously was unaware. In such cases, the auditor shall not issue the auditor's report on the summary FS until the auditor's consideration of such facts in relation to the audited FS in accordance with SA 560 (Revised) has been completed.

v) Auditor's Report on Summary FS -
Elements of the Auditor's Report - The auditor's report on summary FS shall include the following elements:
a. A **title** clearly indicating it as the report of an independent auditor.
b. An **addressee**.
c. An **introductory paragraph** that:
~ **Identifies the summary FS** on which the auditor is reporting, including the title of each statement included in the summary FS;
~ **Identifies the audited FS**;
~ **Refers to the auditor's report** on the audited FS, the date of that report, and, subject to paragraphs 17-18, the fact that an unmodified opinion is expressed on the audited FS;
~ If the **date** of the auditor's report on the summary FS **is later** than the date of the auditor's report on the audited FS, states that the summary FS and the audited FS do not

reflect the effects of events that occurred subsequent to the date of the auditor's report on the audited FS; and
~ A **statement** indicating that the summary FS **do not contain all the disclosures** required by the financial reporting framework applied in the preparation of the audited FS, and that reading the summary FS is not a substitute for reading the audited FS.
d. A **description of management's responsibility** for the summary FS, explaining that management is responsible for the preparation of the summary FS in accordance with the applied criteria.
e. A **statement that the auditor is responsible for expressing an opinion** on the summary FS based on the procedures required by this SA.
f. A paragraph clearly expressing an **opinion.**
g. The **auditor's signature** along with the firm registration number, wherever applicable, and the membership number assigned by ICAI.
h. The **date** of the auditor's report.
i. The **place** of signature.

If the **addressee** of the summary FS is **not the same** as the addressee of the auditor's report on the audited FS, the auditor shall **evaluate** the appropriateness of using a different addressee.

The auditor shall **date** the auditor's report on the summary FS no earlier than:
a. The **date** on which the auditor has **obtained sufficient appropriate evidence** on which to base opinion, including evidence that the summary FS have been prepared & those with the recognised authority have asserted that they have taken responsibility for them;
b. The **date of the auditor's report** on the audited FS.

Modifications to the Opinion, Emphasis of Matter Paragraph or Other Matter Paragraph in the Auditor's Report on the Audited FS - When the auditor's report on the audited FS contains a qualified opinion, an Emphasis of Matter paragraph, or an Other Matter paragraph, but the auditor is satisfied that the summary FS are **consistent,** in all material respects, with or are a fair summary of the audited FS, in accordance with the applied criteria, the auditor's report on the summary FS shall, **in addition** to the elements in paragraph 14:
a. State that the auditor's report on the **audited FS contains** a qualified opinion, an Emphasis of Matter paragraph, or an Other Matter paragraph; and
b. Describe:
~ The **basis** for the qualified opinion on the audited FS, and that qualified opinion; or the Emphasis of Matter or the Other Matter paragraph in the auditor's report on the audited FS;
~ The **effect thereof** on the summary FS, if any.
When the auditor's report on the audited FS contains an **adverse opinion or a disclaimer of opinion**, the auditor's report on the summary FS shall:
a. State that the auditor's report on the audited FS contains an adverse opinion or disclaimer of opinion;
b. Describe the basis for that adverse opinion or disclaimer of opinion; and
c. State that, as a result of the adverse opinion or disclaimer of opinion, it is inappropriate to express an opinion on the summary FS.

Modified Opinion on the Summary FS - If the summary FS are **not consistent**, **in all material respects, with or are not a fair summary** of the audited FS, in accordance with the applied criteria, and management does not agree to make the necessary changes, the auditor shall **express an adverse opinion** on the summary FS.

vi) Restriction on Distribution or Use or Alerting Readers to the Basis of Accounting - When distribution or use of the auditor's report on the audited FS is restricted, or the auditor's report on the audited FS alerts readers that the audited FS are prepared in accordance with a special purpose framework, the auditor shall **include** a **similar restriction or alert** in the auditor's report on the summary FS.

vii) Comparatives - If the audited FS contain comparatives, but the summary FS do not, the auditor shall determine whether such **omission is reasonable** in the circumstances of the engagement. The auditor shall **determine the effect** of an unreasonable omission on the auditor's report on the summary FS.
If the summary FS contain comparatives that were reported on by **another auditor**, the auditor's report on the summary FS shall also contain the matters that **SA 710 (Revised)** requires the auditor to include in the auditor's report on the audited FS.

viii) Unaudited Supplementary Information Presented with Summary FS - The auditor shall **evaluate** whether any unaudited supplementary information presented with the summary FS is **clearly differentiated** from the summary FS. If the auditor concludes that the entity's presentation of the unaudited supplementary information is not clearly differentiated from the summary FS, the auditor shall **ask management to change the presentation** of the unaudited supplementary information. If management **refuses** to do so, the auditor shall **explain** in the auditor's report on the summary FS that such information is **not covered** by that report.

ix) Other Information in Documents Containing Summary FS - The auditor shall **read** other information included in a document containing the summary FS and related auditor's report to identify material inconsistencies, if any, with the summary FS. If, on reading the other information, the auditor identifies a **material inconsistency**, the auditor shall determine whether the summary FS or the other information needs to be **revised**. If, on reading the other information, the auditor becomes aware of an apparent material misstatement of fact, the auditor shall **discuss the matter with management**.

x) Auditor Association - If the auditor becomes aware that the entity **plans to state** that the auditor has reported on summary FS in a document containing the summary FS, **but does not plan to include the related auditor's report**, the auditor shall **request** management **to include** the auditor's report in the document. If management does not do so, the auditor shall determine and carryout other **appropriate actions** designed to prevent management from inappropriately associating the auditor with the summary FS in that document.

The auditor may be engaged to report on the FS of an entity, while not engaged to report on the summary FS. If, in this case, the auditor becomes aware that the entity plans to make a statement in a document that refers to the auditor and the fact that summary FS are derived from the FS audited by the auditor, the auditor shall be **satisfied** that:
a. The **reference** to auditor **is made** in the context of auditor's report on audited FS; and
b. The statement does **not give impression** that auditor has reported on the summary FS.
If (a) or (b) are not met, the auditor shall **request management to change** the statement to meet them, or not to refer to the auditor in the document. **Alternatively**, the entity may engage the auditor to report on the summary FS and include the related auditor's report in the document. If management does **not change** the statement, **delete the reference** to the auditor, or include an auditor's report on the summary FS in the document containing the summary FS, the auditor shall **advise management** that the auditor disagrees with the reference to the auditor, and the auditor shall determine and carry out other **appropriate actions** designed to prevent management from inappropriately referring to the auditor.

SRE 2400 - ENGAGEMENTS TO REVIEW FINANCIAL STATEMENTS

A. Objectives - To enable the auditor to state whether on the basis of less extensive procedures (than required in audit) anything has come to auditor's attention that causes him to believe that FS are not prepared as per appropriate financial reporting framework.

B. Principles - Auditor should comply with code of ethics issued by ICAI i.e.
• Independence • Integrity • Objectivity • Professional competence and due care
• Confidentiality • Professional conduct, and • Technical standards.

C. Scope of Review - It is decided by requirements of this standard, relevant legislation and regulations & terms of Review Engagement.

D. Terms of Engagement Planning - Auditor and client should agree on terms of review engagement to avoid any misunderstanding. Engagement terms should contain
• Objective of the service • Management's responsibility for FS. • Scope of the review, including reference to this standard • Unrestricted access to whatever records, documentation and other information • The fact that the engagement cannot be relied upon to disclose errors, violation of laws or other irregularities • Statement that an audit is not being performed and that an audit opinion will not be expressed

E. Planning: He shall plan for effective performance of review engagement. He should obtain/update the knowledge of the business.

F. Work Performed By Others - Auditor should be satisfied that it is adequate for his purpose.

G. Documentation - Of Important evidences to support review report and compliance with this standard

H. Procedures & Evidences - "Engagements to Review FS", procedures for the review of FS will ordinarily include:
i) Discuss terms and scope of the engagement with the client and the engagement team.
ii) Prepare an engagement letter setting forth the terms and scope of the engagement.
iii) Read the minutes of meetings of shareholders, the board of directors and other appropriate committees in order to identify matters that could be important to the review.
iv) Inquire:
a. if actions taken at shareholder, board of directors or comparable meetings that affect the FS have been appropriately reflected therein.
b. about the existence of transactions with related parties, how such transactions have been accounted for and whether related parties have been properly disclosed.
c. About contingencies and commitments.
d. About plans to dispose of major assets or business segments.
e. whether all financial information is recorded: Completely; Promptly; and After the necessary authorisation.
f. whether there have been any significant changes in the entity from the previous year (e.g., changes in ownership or changes in capital structure).
g. about the accounting policies and consider whether: They comply with the applicable AS; applied appropriately and consistently and, if not, consider whether disclosure has been made of any changes in the accounting policies.
v) Obtain:
a. an understanding of the entity's business activities and the system for recording financial information and preparing FS.

b. the FS and discuss them with management.
c. explanations from management for any unusual fluctuations or inconsistencies in the FS.
d. trial balance and determine whether it agrees with the general ledger and the FS.
vi) Compare the results shown in the current period FS with those shown in FS for comparable prior periods and, if available, with budgets and forecasts.
vii) Consider:
a. the adequacy of disclosure in the FS and their suitability as to classification and presentation.
b. the effect of any unadjusted errors – individually and in aggregate. Bring the errors to the attention of management and determine how the unadjusted errors will influence the report on the review.
c. obtaining a representation letter from management.
d. results of previous audits including accounting adjustments required.

I. Conclusion & Reporting - There should be clear written expression of negative assurance:
i) Title
ii) Addressee
iii) Opening or introductory paragraph including -
a. Identification of the financial statement on which the review had been performed; and
b. A statement of the responsibility of entity's management & the responsibility of auditor
iv) Scope paragraph, including -
a. A reference to this standard & to relevant laws or regulations
b. A statement that a review is limited primarily to inquires and analytical procedures.
c. A statement that
• An audit has not been performed
• The procedures undertaken provide less assurance than an audit
• An audit opinion is not expressed
v) Statement of negative assurance
vi) Date of the report
vii) Place
viii) Auditor's signature and membership number

J. Date of Report: He shall sign the review report as of the date review is completed and date **of** review report by auditor should not he earlier than date of signing/approval by management.

K. Changing Terms of Engagement - If no Justification for changing the terms, Auditor shouldn't agree to change, If not permitted to continue the original engagement. Then withdraw and consider whether any obligation to report these circumstances to other parties (BOD or Shareholders).

L. Negative Assurance - He shall state that -
i) Nothing has come to auditor's attention based on review that causes him to believe that financial statements do not give a true and fair view (or not presented) in accordance with appropriate framework.
ii) If matters come to auditor's attention that impair true and fair view, then describe those matters with quantification on financial statement and either Express qualification of negative assurance, or if effect is so material and pervasive that qualification is not adequate give an adverse statement.
iii) If there is material scope limitation, describe the limitation and either expresses a qualification of negative assurance, or when possible effect of limitation is so significant don't provide any assurance.

SRE 2410 - REVIEW OF INTERIM FINANCIAL INFORMATION PERFORMED BY INDEPENDENT AUDITOR OF THE ENTITY

A. Interim Financial Information (IFI) - IFI is either a complete or condensed set of financial statements for a period shorter than entity's FY.

B. SRE 2410 is applicable when - Independent auditor of the entity is also engaged to review the IFI. He is having understanding of entity and its environment and IC. Thus, he can review IFI with much ease.

C. General Principles of review of IFI – He shall comply with Code of Ethics issued by ICAI, implement quality control procedures as per SQC and maintain professional skepticism.

D. Objectives of This SRE –It is to enable auditor to express a conclusion whether, On the basis of the review, anything has come to auditor's attention, That causes auditor to believe, That IFI is not prepared, in all material respects, in accordance with applicable FRF.

E. Agreeing the Terms of Engagement - Terms of Engagement shall cover the following:
i) Objective of a review of IFI.
ii) Scope of review.
iii) Management's responsibility for:
a. Interim Financial Information
b. Establishing and maintaining effective Internal Control relevant to preparation of IFI.
c. Making all financial records & related information available to auditor.
d. Management's agreement to provide WR to auditor to confirm representations made orally during review, as well as representations implicit in entity's records. Anticipated form and content of report to be issued, including identity of addressee of report. Management's agreement that where any document containing IFI indicates that IFI has been reviewed by entity's auditor, review report will also be included in document.

F. Procedures for a Review
i. Understanding the entity and Its environment - He shall update understanding obtained during annual audits w.r.t. preparation of annual financial statements. Identify types of potential material misstatements and consider likelihood of occurrence. Perform inquiries, analytical & other review procedures. Determine nature of review procedures required for components.
ii. Inquires, Analytical and Other Review Procedures - Auditor shall make inquiries and perform Analytical and Other Review Procedures. Ordinarily auditor is not required to perform inspection/observation/confirmation. Direct external confirmations are also not necessary.
iii. Collection of Evidences - Obtain evidence that the IFI agrees or reconciles with the underlying accounting records. Examine whether management has identified all events up to the date of the review report that may require adjustment to or disclosure in the IFI. Inquire about management's assessment of going concern. When the auditor becomes aware of events or conditions casting significant doubt on the entity's ability to continue as a going concern, the auditor shall perform extended procedures.

G. Evaluation of Misstatements - Evaluate, by exercising professional judgment, whether uncorrected misstatements are material to IFI. However, he is not required to obtain reasonable assurance that WI is free of material misstatements.
i) Representations from Management - For following:
a. Responsibility for internal control to prevent and detect fraud and error.

b. IFI is prepared and presented in accordance with applicable FRF.
c. Uncorrected misstatements are immaterial, both individually and in the aggregate, to IFI.
d. It has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management affecting the entity. Results of its assessment of the risk of fraud. All known actual or possible non-compliance with laws and regulations affecting the IFI. All significant events that have occurred subsequent to the balance sheet date up to the date of the review report that may require adjustment to or disclosure in IFI.

ii) Auditor's Responsibility for Accompanying Information

a. He shall read the other information accompanying the IFI to consider whether it is inconsistent with the IFI.
b. If a matter comes to the auditor's attention that causes the auditor to believe that the other information is misstated, he shall discuss the matter with the entity's management.

H. Reporting –

i) Elements -

a. An appropriate title
b. An addressee, as required by the circumstances of the engagement.
c. Identification of the IFI including title of each statement therein.
d. Management responsibility for preparation of IFI.
e. Statement for Auditor's Responsibility for expressing a conclusion on the IFI.
f. Statement that review of IFI was conducted in accordance with SRE 2410.
g. Statement that review Es substantially less in scope than an audit
h. Auditor's Conclusion.
i. The date of the report,
j. Place of signature.
k. Auditor's signature including his Membership number.
l. Firm registration number.

ii) Departure from applicable FRF -If a matter has come to the auditor's attention that causes the auditor to believe that a material adjustment should have been made to the IFI so that it can comply with applicable FRF then, express a qualified or adverse conclusion.

iii) Limitation on Scope- If he is unable to complete review, communicate the reason in writing to appropriate level of management/TCWG and consider whether it is appropriate to issue a report.

SAE 3400 - THE EXAMINATION OF PROSPECTIVE FINANCIAL INFORMATION

A. Prospective Financial Information (PFI) - It means financial information based on the assumptions about the events that may occur in future and possible action by management. It is, thus, a subjective concept requiring **judgment.** It may be of two types.
i) Forecast - It is based upon assumptions which management expects to take place. (Best estimate assumptions)
ii) Projection - It is based on **(a)** Hypothetical assumptions which are not necessarily expected to take place; or **(b)** Mixture of best estimate and hypothetical assumptions.

B. Management's Responsibility - Management is responsible for preparation of PFI including: • Identification and disclosure of PFI; • The basis of forecast: • Underlying assumptions.

C. Auditor's Duty

i) Auditor may be asked to examine and report **on** it to enhance its credibility.
ii) It relates to events and actions that have not yet occurred and might not occur.
iii) Evidence is future oriented and thus speculative.
iv) Auditor is not in a position to express opinion as to whether the results shown in

prospective financial information will be achieved.
v) He can provide only moderate assurance (Negative assurance).

D. Acceptance of engagement
i) He should not accept or should withdraw from engagement when assumptions are clearly unrealistic or when he believes that it will be inappropriate for its intended use.
ii) Auditor and client should agree on the terms of the engagement.

E. Knowledge of business - Auditor should obtain knowledge of the business so that he can be able to evaluate whether all required assumption have been identified, He should consider the extent of reliance that can be placed on entity's historical financial information (whether it was audited/reviewed, etc.)

F. Period covered - Auditor should consider the time period covered by prospective financial information. Assumption becomes more speculative if length of period covered increases.

G. Examination procedures - While determining NTE of Audit procedure, he should consider -
i) Knowledge obtained during any previous engagement
ii) Management's competence
iii) Likelihood of material misstatement
iv) Extent to which PFI is affected by management's judgment
v) Source of information and their reliability
vi) Stability of entity's business
vii) The experience of engagement team in this connection

H. Documentation - He should keep proper documentation to support his report and to have evidence that he has followed this standard. If report is modified, he should document the reasons also.

I. Report on examination of PFI
i) Title
ii) Addressee
iii) Identification of PFI
iv) Reference to this standard
v) Statement that management is responsible for its preparation.
vi) When applicable, a reference to the purpose and for restricted distribution of PFI.
vii) Statement that examination procedure included examination, on a test basis of evidences supporting the assumptions, amounts and other disclosures in PFI.
viii) Statement of negative assurance as to whether assumptions provide a reasonable basis for PFI.
ix) Opinion as to whether PFI is properly prepared on the basis of assumptions and presented as per relevant financial reporting framework.
x) Appropriate caveats w.r.t. achievability of results indicated by PFI.
xi) Date
xii) Place
xiii) Signature

J. Considerations
i) If presentation and disclosures are not adequate - resign or provide Qualified report.
ii) If significant assumptions don't provide reasonable basis - either resign/adverse report.
iii) If he can't perform necessary procedures - either resign or disclaimer.

SAE 3402 - ASSURANCE REPORTS ON CONTROLS AT A SERVICE ORGANISATION

A. Objectives - The objectives of the service auditor are:
i) To **obtain reasonable assurance** about whether, in all material respects, based on suitable criteria:
a. The service organization's description of its system fairly presents the system as designed and implemented throughout the specified period (or in the case of a type 1 report, as at a specified date);
b. The controls related to the control objectives stated in the service organization's description of its system were suitably designed throughout the specified period (or in the case of a type 1 report, as at a specified date);
c. Where included in the scope of the engagement, the controls operated effectively to provide reasonable assurance that the control objectives stated in the service organization's description of its system were achieved throughout the specified period.
ii) To **report** on the matters in (i) above in accordance with the service auditor's findings.

B. Definitions
i) Carve-Out Method – Method of dealing with the services provided by a subservice organization, whereby the service organization's description of its system includes the nature of the services provided by a subservice organization, but that subservice organization's relevant control objectives and related controls are excluded from the service organization's description of its system and from the scope of the service auditor's engagement. The service organization's description of its system and the scope of the service auditor's engagement include controls at the service organization to monitor the effectiveness of controls at the subservice organization, which may include the service organization's review of an assurance report on controls at the subservice organization.
ii) Complementary User Entity Controls – Controls that the service organization assumes, in the design of its service, will be implemented by user entities, and which, if necessary to achieve control objectives stated in the service organization's description of its system, are identified in that description.
iii) Inclusive Method – Method of dealing with the services provided by a subservice organization, **whereby the service organization's description of its system includes the nature of the services provided by a subservice organization**, and that subservice organization's relevant control objectives and related controls are **included** in the service organization's description of its system and in the scope of the service auditor's engagement.
iv) Report On The Description And Design Of Controls At A Service Organization (Referred To In This SAE As A "Type 1 Report") – A report that comprises:
a. The service organization's **description** of its system;
b. A **written assertion** by the service organization that, in all material respects, and based on suitable criteria:
• The **description** fairly presents the **service organization's system** as designed and implemented as at the specified date;
• The **controls** related to the control objectives stated in the service organization's description of its system were suitably designed as at the specified date; and
c. A service auditor's **assurance report** that conveys reasonable assurance about the matters in (b) above.
v) Report on the description, design and operating effectiveness of controls at a service organization (referred to in this SAE as a "type 2 report") – A report that comprises:
a. The service organization's description of its system;
b. A written assertion by the service organization that, in all material respects, and based on suitable criteria:

• The description fairly presents the service organization's system as designed and implemented throughout the specified period;
• The controls related to the control objectives stated in the service organization's description of its system were suitably designed throughout the specified period; and
• The controls related to the control objectives stated in the service organization's description of its system operated effectively throughout the specified period; and
c. A service auditor's assurance report that:
• Conveys reasonable assurance about the matters in (b) above; and
• Includes a description of the tests of controls and the results thereof.
vi) Service organization's assertion – The written assertion about the matters referred to in paragraph 9(k)(ii) (or paragraph 9(j)(ii) in the case of a type 1 report).
vii) Subservice organization – A service organization used by another service organization to perform some of the services provided to user entities that are likely to be relevant to user entities' internal control as it relates to financial reporting.

C. Requirements
i) Framework for Assurance Engagements - The service auditor shall not represent compliance with this SAE unless the service auditor has complied with the requirements of this SAE and the requirements of the Framework for Assurance Engagements.

ii) Ethical Requirements - The service auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to assurance engagements.

iii) Management and Those Charged with Governance - The service auditor shall determine the appropriate person(s) within the service organization's management or governance structure with whom to interact.

iv) Acceptance and Continuance - Before agreeing to accept, or continue, an engagement the service auditor shall:
a. Determine whether:
• The service auditor has the **capabilities and competence** to perform the engagement;
• The **criteria** to be applied by the service organization to prepare the description of its system will be suitable and available to user entities and their auditors; and
• The **scope** of the engagement and the service organization's description of its system will not be so limited that they are unlikely to be useful to user entities and their auditors.
b. Obtain the agreement of the service organization that it acknowledges and understands its **responsibility**
If the service organization requests a change in the scope of the engagement before the completion of the engagement, the service auditor shall be satisfied that there is a reasonable justification for the change.

v) Assessing the Suitability of the Criteria: In assessing the suitability of the criteria to evaluate the service organization's description of its system, the service auditor shall determine if the criteria encompass, at a minimum:
a. Whether the description presents how the service organization's system was designed and implemented,
b. In the case of a type 2 report, whether the description includes relevant details of changes to the service organization's system during the period covered by the description.
c. Whether the description omits or distorts information relevant to the scope of the service organization's system being described, while acknowledging that the description is prepared to meet the common needs of a broad range of user entities

vi) Materiality: When planning and performing the engagement, the service auditor shall consider materiality with respect to the fair presentation of the description, the suitability of the design of controls and, in the case of type 2 reports, the operating effectiveness of controls.

vii) Obtaining an Understanding of the Service Organization's System: The service auditor shall obtain an understanding of the service organization's system, including controls that are included in the scope of the engagement.

viii) Obtaining Evidence Regarding the Description: The service auditor shall obtain and read the service organization's description of its system, and shall evaluate whether those aspects of the description included in the scope of the engagement are fairly presented,

ix) Obtaining Evidence Regarding Design of Controls: The service auditor shall determine which of the controls at the service organization are necessary to achieve the control objectives stated in the service organization's description of its system, and shall assess whether those controls were suitably designed.

x) Obtaining Evidence Regarding Operating Effectiveness of Controls: When providing a type 2 report, the service auditor shall test those controls that the service auditor has determined are necessary to achieve the control objectives stated in the service organization's description of its system, and assess their operating effectiveness throughout the period. Evidence obtained in prior engagements about the satisfactory operation of controls in prior periods does not provide a basis for a reduction in testing, even if it is supplemented with evidence obtained during the current period.

a. Sampling - When the service auditor uses sampling, the service auditor shall:

- Consider the purpose of the procedure and the characteristics of the population from which the sample will be drawn when designing the sample;
- Determine a sample size sufficient to reduce sampling risk to an appropriately low level;
- Select items for the sample in such a way that each sampling unit in the population has a chance of selection;
- If a designed procedure is not applicable to a selected item, perform the procedure on a replacement item; and
- If unable to apply the designed procedures, or suitable alternative procedures, to a selected item, treat that item as a deviation.

b. Nature and Cause of Deviations: The service auditor shall investigate the nature and cause of any deviations identified and shall determine whether Identified deviations are within the expected rate of deviation and are acceptable, Additional testing of the control or of other controls is necessary to reach a conclusion.

xi) The Work of an Internal Audit Function

a. Obtaining an Understanding of the Internal Audit Function: If the service organization has an internal audit function, the service auditor shall obtain an understanding of the nature of the responsibilities of the internal audit function and of the activities performed in order to determine whether the internal audit function is likely to be relevant to the engagement.

b. Determining Whether and to What Extent to Use the Work of the Internal Auditors: The service auditor shall determine:

- Whether the work of the internal auditors is likely to be adequate for purposes of the engagement; and
- If so, the planned effect of the work of the internal auditors on the nature, timing or extent of the service auditor's procedures.

In determining whether the work of the internal auditors is likely to be adequate for purposes of the engagement, the service auditor shall evaluate:
• The objectivity of the internal audit function;
• The technical competence of the internal auditors;
c. Using the Work of the Internal Audit Function: In order for the service auditor to use specific work of the internal auditors, the service auditor shall evaluate and perform procedures on that work to determine its adequacy for the service auditor's purposes.
d. Effect on the Service Auditor's Assurance Report: If the work of the internal audit function has been used, the service auditor shall make no reference to that work in the section of the service auditor's assurance report that contains the service auditor's opinion. In the case of a type 2 report, if the work of the internal audit function has been used in performing tests of controls, that part of the service auditor's assurance report that describes the service auditor's tests of controls and the results thereof shall include a description of the internal auditor's work and of the service auditor's procedures with respect to that work.

xii) Written Representations: The service auditor shall request the service organization to provide written representations:
a. That re-affirms the assertion accompanying the description of the system;
b. That it has provided the service auditor with all relevant information
c. That it has disclosed to the service auditor any of the following of which it is aware:

xiii) Other Information: The service auditor shall read the other information, if any, included in a document containing the service organization's description of its system and the service auditor's assurance report, to identify material inconsistencies, if any, with that description. While reading the other information for the purpose of identifying material inconsistencies, the service auditor may become aware of an apparent misstatement of fact in that other information. If the service auditor becomes aware of a material inconsistency or an apparent misstatement of fact in the other information, the service auditor shall discuss the matter with the service organization. If the service auditor concludes that there is a material inconsistency or a misstatement of fact in other information that the service organization refuses to correct, the service auditor shall take further appropriate action.

xiv) Subsequent Events: If the service auditor is aware of such an event, and information about that event is not disclosed by the service organization, the service auditor shall disclose it in the service auditor's assurance report. The service auditor has no obligation to perform any procedures regarding the description of the service organization's system, or the suitability of design or operating effectiveness of controls, after the date of the service auditor's assurance report.

xv) Documentation: The service auditor shall prepare documentation that is sufficient to enable an experienced service auditor, having no previous connection with the engagement, to **understand:**
a. The **nature, timing, and extent of the procedures performed** to comply with this SAE and applicable legal and regulatory requirements;
b. The **results** of the procedures performed, and the evidence obtained; and
c. Significant matters arising during the engagement, and the **conclusions** reached thereon and **significant professional judgments** made in reaching those conclusions.

xvi) Preparing the Service Auditor's Assurance Report
a. Content of the Service Auditor's Assurance Report - The service auditor's assurance report shall include the following basic elements:

• **A title** that clearly indicates the report is an independent service auditor's assurance report.
• An **addressee.**
• **Identification** of:
~ The service organization's **description of its system,** and the service organization's assertion
~ Those parts of the service organization's description of its system, if any, that **are not covered** by the service auditor's opinion.
~ If the description refers to the need for complementary user entity controls, a **statement** that the service auditor has **not evaluated the suitability of design** or operating effectiveness of complementary user entity controls,
~ If services are performed by a subservice organization, **the nature of activities performed by the subservice organization** as described in the service organization's description of its system and whether the **inclusive method or the carve-out method** has been used in relation to them.
• Identification of the **criteria**, and the party specifying the control objectives.
• A statement that the report and, in the case of a type 2 report, the description of tests of controls are intended only for user entities and their auditors,
• A statement that the service organization is responsible for:
~ Preparing the description of its system, and the accompanying assertion, including the completeness, accuracy and method of presentation of that description and that assertion;
~ Providing the services covered by the service organization's description of its system;
~ Stating the control objectives (where not identified by law or regulation, or another party, for example, a user group or a professional body); and
~ Designing and implementing controls to achieve the control objectives stated in the service organization's description of its system.
• A statement that the service auditor's responsibility is to express an opinion on the service organization's description, on the design of controls related to the control objectives stated in that description and, in the case of a type 2 report, on the operating effectiveness of those controls, based on the service auditor's procedures.
• A statement that the engagement was performed in accordance with SAE 3402,
• A summary of the service auditor's procedures to obtain reasonable assurance
• A statement of the limitations of controls and, in the case of a type 2 report, of the risk of projecting to future periods any evaluation of the operating effectiveness of controls.
• The service auditor's opinion, expressed in the positive form, on whether, in all material respects, based on suitable criteria:
~ In the case of a type 2 report:
→ The description fairly presents the service organization's system that had been designed and implemented throughout the specified period;
→ The controls related to the control objectives stated in the service organization's description of its system were suitably designed throughout the specified period; and
→ The controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the specified period.
~ In the case of a type 1 report:
→ The description fairly presents the service organization's system that had been designed and implemented as at the specified date; and
→ The controls related to the control objectives stated in the service organization's description of its system were suitably designed as at the specified date.
• The date of the service auditor's assurance report, which shall be no earlier than the date on which the service auditor has obtained sufficient appropriate evidence on which to base the opinion.

• Practitioner's Signature-The report should be signed by the practitioner in his personal name. Where the firm is appointed, the report should be signed in the personal name of the engagement partner and in the name of the firm. He shall mention the membership number the registration number of the firm.
• The place of signature – the report should name specific location, which is ordinarily the city where the report is signed.

b. Modified Opinions - If the service auditor concludes that:
• The service organization's description does not fairly present, in all material respects, the system as designed and implemented;
• The controls related to the control objectives stated in the description were not suitably designed, in all material respects;
• In the case of a type 2 report, the controls tested, which were those necessary to provide reasonable assurance that control objectives stated in the service organization's description of system were achieved, did not operate effectively, in all material respects; or
• The service auditor is unable to obtain sufficient appropriate evidence, the service auditor's opinion shall be modified, and the service auditor's assurance report shall contain a clear description of all the reasons for the modification.

xvii) Other Communication Responsibilities - If the service auditor becomes aware of non-compliance with laws and regulations, fraud, or uncorrected errors attributable to the service organization that are not clearly trivial and may affect one or more user entities, the service auditor shall determine whether the matter has been communicated appropriately to affected user entities. If the matter has not been so communicated and the service organization is unwilling to do so, the service auditor shall take appropriate action.

SRS 4400 - ENGAGEMENT TO PERFORM AGREED UPON PROCEDURE REGARDING FINANCIAL INFORMATION

A. Objective – The objective is to carry out procedure of audit nature, to which the auditor and the entity and any appropriate third parties have agreed and to report on factual finding thereon. The report is generally restricted to those parties that have agreed to the procedures to be performed.

B. Principles Of Agreed Upon Procedure - Auditors should comply with the Code of Ethics issued by ICAI. Ethical principle are: **(i)** Integrity; **(ii)** Objectivity **(iii)** Professional competence and due care; **(iv)** Confidentiality **(v)** Professional conduct; and **(vi)** Technical standard. Independence is not required compulsorily. But if he's not independent, he should refer it in his Report

C. Defining Terms Of Engagement - There should be clear understanding regarding the agreed procedures including the following:
(i) Nature of the engagement **(ii)** Purpose **(iii)** Identification of the financial information **(iv)** Nature, timing and extent of the specific procedures **(v)** Limitation on distribution of the report of factual findings If such limitation would be in conflict with the legal requirements, the auditor would not accept the engagement.

D. Planning – The auditor should plan the work so that an effective engagement can be performed.

E. Documentation – He shall document important matters to support the report of factual findings and to provide evidence that engagement was performed as per this standard and terms of engagement

F. Procedures & Evidence - Auditors should carry out agreed upon procedures (such as computation, comparison, observation, inspection and obtaining confirmations) to use evidence obtained there from as basis for report of factual findings.

G. Reporting - The report of factual findings should contain:
i) Title;
ii) Addressee;
iii) Identification of specific financial or non-financial information to which the agreed- upon procedures have been applied.
iv) A statement that the procedures performed was those agreed-upon with the recipient.
v) A statement that the engagement was performed in accordance with this standard and terms of engagement.
vi) Identification of the purpose.
vii) A listing of the specific procedures performed.
viii) A description of the auditor's factual findings including sufficient details of errors and exceptions found.
ix) A statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed.
x) A statement that the report is restricted to those parties that have agreed to the procedures to be performed.
xi) A statement (when applicable) that the report relates only to the elements and that it does not extend to the entity's financial statements taken as a whole
xii) Date of the report.
xiii) Place of signature.
xiv) Auditor's signature.
Report should be signed by the auditor in his personal name. Where the firm is appointed, the report should be signed in the personal name of the auditor and in the name of the firm. Also mention the membership number.

SRS 4410 - ENGAGEMENTS TO COMPILE FINANCIAL INFORMATION

A. Objective of Compilation Engagement – The objective is to collect, classify and summaries financial information by using accounting expertise.

B. Principles of a Compilation Engagement - Auditors should comply with the Code of Ethics issued by ICAI. Ethical principle are: **(i)** Integrity; **(ii)** Objectivity **(iii)** Professional competence and due care; **(iv)** Confidentiality (v) Professional conduct; and **(vi)** Technical standard. Independence is not required compulsorily. But if he's not independent, he should refer it in his Report

C. Management's Responsibility –The management is responsible for:
i) Ensuring correctness & completeness of **financial information** generated in the entity.
ii) Maintaining **Accounting Records** and **Internal Controls.**
iii) Selecting and applying appropriate **accounting policies.**
iv) Establishing controls for safeguarding the assets **and detecting frauds.**
v) Ensuring compliance with **laws** and regulation.
vi) Complete disclosure of all material and relevant information to the accountant.

D. Defining terms of engagement - He should send an engagement letter listing the key terms of appointments to **avoid** misunderstanding. It includes the following:
i) Nature of the **engagement.**
ii) Fact that engagement can't be relied upon to **disclose fraud,** etc. but if accountant

comes across any such matter, he'll tell management about same.
iii) Nature of information to be supplied by client.
iv) Fact that management is responsible for:
a. Complete disclosure of all material and relevant information to the accountant;
b. Ensuring correctness & completeness of financial information generated in the entity;
c. Maintaining Accounting Records and Internal Controls;
d. Selecting and applying appropriate accounting policies;
e. Establishing controls for safeguarding the assets and detecting frauds;
f. Ensuring compliance with laws and regulation.
v) Intended use and distribution of information.
vi) Basis of accounting.
vii) Unrestricted access to documents records etc.
viii) Basis for fee computation and billing arrangements
ix) Fact that management is responsible to users for compiled information
x) Request for client to confirm the terms of engagement by acknowledging receipt of engagement letter.

E. Planning - He should plan the work for effective performance of work.

F. Documentation - – He shall document important matters to provide evidence that engagement was performed as per this standard and terms of engagement.

G. Procedures and evidences
i) General Procedures - He should –
a. Obtain the general knowledge of business and operations of the entity
b. Be familiar with Accounting principles and practices of industry in which entity operates
c. Understand form and content of financial statements / information which is appropriate in the circumstances.
d. Request management representation letter on significant matters
e. Read compiled information to consider whether it appears to be appropriate in form and free from obvious misstatement
ii) Procedures in exceptional circumstances - If information by management is expected to be incorrect, incomplete, or unsatisfactory, than he should **make enquiries of management**, assess internal controls, or verify any matters and explanations. He shall request management to provide additional information; If management **refuses to provide additional information**; he should withdraw from engagement informing entity of the reasons for the withdrawal

H. Special Consideration
i) For Clients having

Identified Financial Reporting Framework	**No Identified Financial Reporting Framework**
If material departure from requirements of same, it should be included in:	Different basis of compilation should be included in:
(i) Notes to A/c and (ii) Accountant's report on compilation	(i) Notes to A/c and (ii) Accountant's report on compilation

ii) Non - Compliance with applicable Accounting Standard - He should bring this to management's attention; if not rectified by management; it should be included in Notes to accounts and Accountants report.
iii) If it appears to accountant that some estimate is unreasonable, he should draw management's attention towards this.
iv) If he becomes aware of material misstatements - Accountant should persuade management to amend the financial information. If management doesn't make them and

thus financial information is still misleading; Accountant should withdraw from engagement
v) Financial information compiled should be approved by client before signing the compilation report by accountant. The word 'audit' should not be used anywhere. He shouldn't prepare financial statements etc. on his letter head as it may mislead the user.

I. Report
i) Title: Title of the report should be "Accountant's Report on Compilation of Un- audited Financial Statements.
ii) Addressee: 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.
vi) A statement that the engagement was performed in accordance with this standard;
vii) A statement that neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information;
viii) A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the identified financial reporting framework;
ix) Date of report
x) Place
xi) Accountant's signature: The report on compilation of financial information should be signed by the accountant in his personal name and in the name of the firm. Also mention the membership number.
xii) Financial statements compiled by the accountant should contain a reference such as "Unaudited", "Compiled without Audit or Review" and also "Refer to Compilation Report" on each page or on the front of financial statements.

SQC 1 - QUALITY CONTROL FOR FIRMS THAT PERFORM AUDIT AND REVIEWS OF HISTORICAL FINANCIAL INFORMATION AND OTHER ASSURANCE & RELATED SERVICES ENGAGEMENTS

A. Definitions -
i) Engagement Partner - Partners other person in firm (C.A full time in practice) responsible for engagement & report thereon.
ii) Engagement Quality Control (Q.C.) Review - Process to evaluate the judgment & conclusions of Engagement Team before report is issued.
iii) Engagement Q.C. Reviewer – Partner/Other person in firm /external person or a team to conduct Review.
iv) Network Firm - Entity under common control ownership or management with firm (Nationally / internationally).

B. <u>Elements of Quality Control</u> - Firms Q.C. should include Policies w.r.t. following -

<u>i) Leadership Responsibilities for Quality within firm</u>

a. Establish Policies & Procedures to promote good internal culture.
b. CEO/Managing partners should assume ultimate responsibility for firm's **Q.C.**
c. They should assign these responsibilities to experienced and able persons in the firm.

<u>ii) Ethical Requirements</u> - Establish policies & Procedures to ensure compliance with following:
a. Integrity
b. Objectivity
c. Professional competence & due care
d. Confidentiality
e. Professional behavior
They should ensure Proper (w.r.t. above (a)-(e) points) - Education & Training, Monitoring, Process for dealing with non- compliance, Leadership.

<u>iii) Independence</u>

a. Establish Q.C. to maintain Independence. Thus:
• Communicate Independence requirements to personnel
• Identify threats to Independence
• Try to eliminate those threats or to withdraw from engagements
b. Such policies & procedures should require:
• Engagement Partner to inform the firm about client engagements so that firm can evaluate the impact on independence.
• Personnel to promptly notify firm any threat to independence.
• Communication of relevant information to appropriate personnel to comply with independence requirements and action to be taken in case of breach of same.
c. In case of breach of independence, firm should communicate the same to relevant EP & other personnel so that they can take appropriate action for the same.
d. At least annually, firm should obtain written confirmation of compliance with independence from relevant firm personnel.
e. They should set criteria for reducing the familiarity threat (when same personnel are performing an engagement over a long time).
(E.g.:- For listed entity, audit engagement partner should be rotated after pre- defined period maximum 7 Years).

<u>iv) Acceptance & continuance of client relationship and specified engagements</u>

a. Ensure that it will undertake / continue relationships only where it: -
• Has considered integrity of client • Is competent to perform the engagement.
• Can comply with ethical requirements
b. In case, such issues are identified & firm takes up! continue the engagement; it should document how issues were resolved.
c. After taking up work, if firm obtains information that would have caused it to decline an engagement if information had been available earlier, then consider -
• Communicating it to appointing authority & regulatory authority; & • Possibility of withdrawing from the engagement or form both the engagement & client relationship.

<u>v) Human Resources</u> - a. Establish Q.C polices & Procedure to reasonable assure that it has sufficient personnel (capable, competent & committed) to perform its engagement as per professional standard & regulatory requirements & to issue appropriate reports.
b. Firm should assign appropriate staff to perform engagements.

vi) Engagement Performance - Establish Q.C to reasonably assure that engagements are performed as per Professional standards & legal requirements & report is appropriate in circumstances.

a. Consultation - Ensure:
• Consultation of different matters.
• Documentation of consultation.
• That conclusions of consultation are also documented.

b. Difference of opinion - Establish Q.C to resolve difference of opinion within engagement Team, with those consulted & engagement partner & engagement Q.C reviewer (Documentation also).After resolution of matter, report is issued.

c. Engagement Q.C Review - Ensure:
• Q.C reviews for all audits of listed entities.
• Criteria to determine whether an engagement Q.C Review should be performed &
• Engagement Q.C Review for all engagement meeting aforesaid criteria.
It should be completed before report is issued.

Also decide the:
~ NTE of engagement Q.C Review,
~ Eligibility criteria for reviewers &
~ Documentation requirements for reviews.
• Reviewer should be technically competent and objective.

d. Completion of assembly of final engagement Files -
Assembly of files on a timely basis after engagement reports have been finalized.

e. Confidentiality etc. of engagement Documentation:
• Ensure confidentiality, safe custody, integrity, accessibility and irretrievability of engagement documentation.
• Ensure retention of engagement documentation for sufficient period. (At least for 7 years)

vii) Monitoring

a. Q.C Policies & Procedure to ensure that Q.C. system is adequate, relevant, operating effectively and complied with in practice.

b. It includes ongoing evaluation of firms system of Q.C. including a periodic inspection of completed engagements.

c. Evaluate effect of deficiencies:
• Instances that may not indicate insufficiency of firm **Q.C**
• Systematic, repetitive or other significant deficiencies requiring prompt corrective action.

d. Firm should communicate to relevant engagement partner, deficiencies noted.

e. When indication as to inappropriateness of report or omission of necessary procedures, the firm should determine further action (legal advice).

f. At least annually, the firm should communicate the result of monitoring to its engagement partners & firm's CEO / managing partners, information including:
• Description of monitoring procedures
• Conclusion of monitoring procedures
• Significant deficiencies & action taken (if any)

g. Firm should also ensure proper dealing with complaints & Allegations about non Compliance with legal or Professional standards & firm's system of Q.C.

C. Documentation - Firm should keep documentation as to operation of each element of its system of Q.C.

CASE STUDIES

Q1. While auditing Z Ltd., you observe certain material FS assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements?
Hint Ans: Refer SA 540 Point No. D-iv

Q2. The management of S Ltd. requests you not to seek confirmation from its debtors. As the auditor of S Ltd., what can be an appropriate response?
Hint Ans: Refer SA 505 Point No. C (ii)

Q3. The audit report of P Ltd. for the year 2008-09 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2009-10, how would you report, if?
(a) The company does not make provision for doubtful debts in 2008-09?
(b) The company makes adequate provision for doubtful debts in 2008-09?
Hint Ans: Refer SA 710 Point No. E-(ii-a)
In the instant Case, if P Ltd. does not make provision for doubtful debts the auditor will have to modify his report for both current and previous year's figures as mentioned above. If however, the provision is made, the auditor need not refer to the earlier year's modification.

Q4. The directors of C Ltd. are concerned about the reliability and usefulness of the monthly financial management information that they receive. As a result, the company's auditors have been engaged to review the system and the information it generates, and to report their conclusions.
(a) What an ordinary procedure includes for the review of FS?
(b) Contrast this assignment with the statutory audit of the company's financial statements with regard to the scope of the assignment and to the report issued.
Hint Ans: (a) Refer SRE 2400 Point No. H
(b) Contrast of a review assignment with the statutory audit of the company's FS with regard to the scope of the assignment and to the report issued is hereunder:

SCOPE	
Review assignment	Statutory audit
Scope of Review assignments are generally falls in agreement between parties	Scope of Statutory audit should be in accordance with the Companies Act, 1956 or in accordance with other statute.
Scope of Review assignments is restricted to instructions	Scope of Statutory audit should be in accordance with Audit Regulations and Norms
Review assignment should be done in accordance with SREs	Statutory audit should be conducted in accordance with SAs, 14 Statements and Guidance Notes etc

REPORT	
Review assignment	**Statutory audit**
Report of Review Assignment is addressed to the board	Statutory Audit Report is addressed to the members
Format of Report of Review assignment is wholly discretionary	Statutory Audit Report is on true and fair view and as per prescribed format.
Report of Review Assignment is private report	Statutory Audit Reports are in public domain

Q5. You are appointed statutory auditor of X Ltd. X Ltd. has an internal audit system and reports for the same are given to you. Mention the factors you will consider to ensure that the said system of internal audit of X Ltd. is commensurate with the size of the company and nature of its business.
Hint Ans: **Refer** "SA 610" Point No. D (ii)

Q6. You are an audit senior working for the firm Kala & Company. You are currently carrying out the audit of W Ltd., a manufacturer of waste paper bins. You are unhappy with W Ltd.'s inventory valuation policy and have raised the issue several times with the audit manager. He has dealt with the client for a number of years and does not see what you are making a fuss about. He has refused to meet you on site to discuss these issues. The former engagement partner to W Ltd. retired two months ago. As the audit manager had dealt with W Ltd. for so many years, the other partners have decided to leave the audit of W Ltd. in his capable hands. Comment on the situation outlines above.
Hint Ans: **Refer** SA 220 Point No. C-(vi-e)

Q7. While commencing the statutory audit of B Company Limited, the auditor undertook the risk assessment and found that the detection risk relating to certain class of transactions cannot be reduced to acceptance level.
Hint Ans: SA 315 and SA 330 "Identifying and Assessing the Risk of Material Misstatement Through Understanding the Entity and its Environment" and "The Auditor's Responses to Assessed Risks" establishes standards on the procedures to be followed to obtain an understanding of the accounting and IC systems and on audit risk and its components: inherent risk, control risk and detection risk. SA 315 and SA 330 require that the auditor should use professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. "Detection risk" is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material. The higher the assessment of inherent and control risks, the more audit evidence the auditor should obtain from the performance of substantive procedures. When both inherent and control risks are assessed as high, the auditor needs to consider whether substantive procedures can provide sufficient appropriate audit evidence to reduce detection risk, and therefore audit risk, to an acceptably low level. The auditor should use his professional judgement to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level. If it cannot be reduced to an acceptable level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.

Q8. While auditing accounts of a public limited company for the year ended 31st March 2011, an auditor found out an error in the valuation of inventory, which affects the FS materially – Comment as per standards on auditing.
Hint Ans. **Refer** SA 240 Point No. E-vi (b), (c) and (d)

Q9. At the statutory audit of TOR Limited, the physical verification of fixed assets was conducted. However the auditor was not able to confirm the existence of valuables and important machinery. In this connection, the auditor obtained a certificate from the management to prove its existence and value and accepted the same blindly without any further procedures.
Hint Ans: The physical verification of fixed assets is the primary responsibility of the management. The auditor, however, is required to examine the verification programme. Further, he must satisfy himself about the existence, ownership, procession and valuation of fixed assets. It appears from the facts of the case that the auditor has not been able to verify either existence or valuation of significant fixed assets despite conducting physical verification audit procedure himself. Ultimately, he accepted the certificate from the

management without performing further procedures. As per **SA 580 (Revised),** "Written Representations", representation by management **cannot be a substitute** for other audit evidence that the auditor could reasonably expect to be available. Thus, a representation by management as to the existence of valuables and machinery is no substitute for adopting normal audit procedures regarding verification of valuable and important machinery. If the auditor is unable to obtain sufficient appropriate audit evidence that he believes will be available, this will constitute a limitation on the scope of his examination even if he has obtained a representation from management on the matter and the auditor may express a disclaimer of opinion.

Q10. In the course of the audit of R Ltd., the audit manager of ABC & Co. observed that R Ltd. has outsourced certain activities to an outsourcing agency. As the engagement partner guide the audit manager in the assessment of services provided by the outsourcing agency in relation to the audit.
Hint Ans: Refer SA 402 Point No. E (i)

Q11. In the course of audit of T Ltd., the audit team is not sure of the possible source of misstatements in the FS. As the audit manager identify the sources of misstatements.
Hint Ans: Refer SA 450 Point No. B (ii)

Q12. The teeming & lading fraud was detected and the amount involved was subsequently deposited by the Executive Director of the company & therefore, need not be reported upon.
Hint Ans: It will be necessary for the auditor to bring to the notice of the shareholders about the teeming and lading fraud since the same had been committed by the Executive Director. Such an event shows that the **internal control systems** are quite weak in the organization and the top **management** is in a position to **abuse its authority**. The mere fact that no loss to the company has occurred would not preclude the auditor from bringing it to the notice of the shareholders. A **suitable disclosure** is called for, particularly, in view of the fact that the fraud has been committed by the Executive Director. Even **SA-240 (Revised)** on Auditors responsibilities relating to the fraud in an audit of FS require specifically, if the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management is involved, the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the NTE of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained.
Conclusion: Thus, the auditor should also consider the implications of the circumstances on the true and fair view which the FS ought to convey and frame his report accordingly.
[Note: The question does not specify the amount of money involve. Therefore, it is difficult to apply the criterion of materiality.]

Q13. "Auditor's assessment of materiality may be different at the time of planning the engagement than at the time of evaluating the results of his audit procedures". Discuss.
Hint Ans: SA 320 on "Materiality in Planning and Performing an Audit" recommends that the concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the FS and in forming the opinion in the auditor's report. **SA 450** "Evaluation of Misstatements Identified during the Audit", explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the FS. While formulating an overall audit plan, **SA 300 (Revised)** on "Planning an Audit of FS" also requires the auditor to consider the

setting of materiality levels for audit purpose right from the initial stages and throughout the process of conducting the audit till the audit opinions is formulated.
However, the auditor's assessment of materiality may be **different** at the time of initially planning the engagement than at the time of evaluating the results of his audit procedures. Since audit materiality related to specific amount balances and classes of transactions, helps the auditor decide such questions as what items to examine and whether to use sampling and analytical procedures. This enables the auditor to select audit procedures that, in combination, can be expected to support the audit opinion at an acceptably low degree of audit risk. Such selection of audit procedures would undergo a change as audit work progress. The assessment of materiality and audit risk the stage of evaluating the results of audit procedures would also change because of a change in circumstances or a change in the auditor's knowledge as results of audit. For example, if the audit is planned prior to period end, the auditor will anticipate the results of operations and the financial position. If actual results of operations and financial position are substantially different, the assessment of materiality and audit risk may also change. Additionally the auditor may, in planning the audit work, intentionally set the acceptable cut-off level for verifying individual transactions at a lower level than is intended to be used to evaluate the results of the audit. This may be done to cover a larger number of items and thereby reduce the likelihood of undiscovered misstatements and to provide the auditor with the major of safety when evaluating the effect of misstatements discovered during the audit.

QUESTIONS

Q1. Comment on the following:
(a) You are the auditor of Easy Communications Ltd. for the year 2007–08. The inventory as at the yearend i.e. 31.3.08 was Rs. 2.25 crores. Due to unavoidable circumstances, you could not be present at time of annual physical verification. Under the above circumstances how would you ensure that the physical verification conducted by the management was in order? (5 Marks) **(Nov 2008)**
(b) You have been appointed as auditor of Good Health Ltd. for 2007-08 which was audited by CA Trustworthy in 2006-07. As the Auditor of company state the steps you would take to ensure that the Closing Balances of 2006-07 have been brought to account in 2007-08 as Opening Balances & Opening Balances do not contain misstatements.(5 Marks) **(Nov 2008)**

Q2. Short notes on Frauds through supplier ledger (4 Marks) **(Nov 2008 & May 2011)**

Q3. (a) In the course of the audit of R Ltd., the audit manager of ABC & Co. observed that R Ltd. has outsourced certain activities to an outsourcing agency. As the engagement partner guide the audit manager in the assessment of services provided by the outsourcing agency in relation to the audit. (4 Marks) **(May 2011)**
(b) In the course of audit of T Ltd., the audit team is not sure of the possible source of misstatements in FS. Identify the sources of misstatements. (4 Marks) **(May 2011)**
(c) While auditing Z Ltd., you observe certain material FS assertions have been based on estimates made by the management. As the auditor how do you minimize the risk of material misstatements? (6 Marks) **(May 2011)**
(d) The management of S Ltd. requests you not to seek confirmation from its debtors. As the auditor of S Ltd., what can be an appropriate response?(6 Marks) **(May 2011)**

Q4. Y Ltd. engaged an actuary to ascertain its employee cost, gratuity & leave encashment liabilities. As the auditor of Y Ltd., you would like to use the report of the actuary as audit evidence. How do you evaluate the work of the actuary? (8 Marks) **(May 2011)**

Q5. Short notes on Guidance note on Audit of Misc. Expenditure. (4 Marks) **(Nov 2010)**

Q6. While doing audit, Ram, the Auditor requires reports from experts for the purpose of Audit evidence. What types of reports/opinions he can obtain and to what extent he can rely upon the same? (4 Marks) **(Nov 2010)**

Q7. (a) In the course of audit of ABC Ltd. its management refuses to provide written representations. As an auditor what is your duty? (4 marks) **(May 2010)**
(b) While planning the audit of S Ltd. you want to apply sampling techniques. What are the risk factors you should keep in mind? (4 marks) **(May 2010)**
(c) Auditor's responsibilities in respect of corresponding figures? (4 marks) **(May 2010)**
(d) IT systems also pose specific risks to an entity's internal control? What are those risks? (4 Marks) **(May 2010)**

Q8. Answer the following:
(a) You are appointed statutory auditor of X Ltd. X Ltd. has an internal audit system and reports for the same are given to you. Mention the factors you will consider to ensure that the said system of internal audit of X Ltd. is commensurate with the size of the company and nature of its business. (8 Marks) **(June 2009)**
(b) Audit report of P Ltd. for year 2007-08 contained a qualification regarding non-provision of doubtful debts. As auditor of company for the year 2008-09, how would you report, if:
i) The company does not make provision for doubtful debts in 2008-09?
ii) Company makes adequate provision for doubtful debts? (8 Marks) **(June 2009)**

Q9. Moon Limited replaced its statutory auditor for the financial year 2008-09. During the course of audit, the new auditor found a credit item of Rs. 5 lakhs. On enquiry, the company explained him that it is, a very old credit balance. The creditor had neither approached for the payment nor is he traceable. Under the circumstances, no confirmation of the credit balance is available. Comment (5 Marks) **(Nov 2009)**

Q10. Explain briefly duties and responsibilities of an auditor in case of material misstatement resulting from Management Fraud. (6 Marks) **(Nov 2009)**

Q11. Briefly explain the audit procedures on subsequent events (4 Marks) **(Nov 2009)**

Q12. Comment on the following:
(a) You are appointed to compile FS of Y & Co. for tax purposes. During the course of work, you learn that the inventory is grossly understated. On pointing the same, the partners of Y & Co. tell you that since you are not conducting an audit, the said figures duly certified by the firm should be accepted. (5 Marks) **(June 2009)**
(b) While conducting statutory Audit of ABC Ltd., you come across IOUs amounting to Rs. 2 crores as against a cash balance shown in books of Rs. 2.10 crores. You also observe that despite similar high balances throughout the year, small amounts of Rs. 50,000 are withdrawn from the bank to meet day-to-day expenses. (5 Marks) **(June 2009)**

3. AUDIT STRATEGY, PLANNING & PROGRAMMING

3.1. Audit Programme

i) An audit programme is a **written plan** for the conduct of an audit specifying **what work to be done, when to be done and by whom to be done.**
ii) Audit Programme consists of a **series of verifications procedure** to be followed to the financial statements and accounts of a given company for the purpose of obtaining sufficient and appropriate evidence to enable the auditor to express an informed **opinion** on such statements.
iii) Audit Programme is formulated on the basis of **knowledge of the clients business** and **nature of controls** operating in the organisation.
iv) Audit programme should be **flexible** and must be **reviewed** to keep it up to date.
v) Planning is a continuous process and changes in conditions or unexpected results of audit procedures may cause revisions of the overall plan as well as the detailed audit programme.
vi) Objectives - Careful and adequate audit planning is helpful in:
(**a**) ensuring devotion of appropriate attention to important areas of the audit, (**b**) promptly identifying potential problems, (**c**) completing the work expeditiously, (**d**) proper utilisation of assistants, and (**e**) co-ordination of work done by other auditors and experts.

3.2. Important Matters To Be Considered While Formulating An Audit Programme

i) Nature of business in which the organization is engaged
ii) Overall **plan** prepared for the audit
iii) System of **internal control and accounting procedures**
iv) Acquiring knowledge of **Size** of the organization
v) Determine structure of its **management**
vi) Information regarding the **organization** of the business
vii) Acquiring knowledge of clients **Accounting and management policies**
viii) Coordinating the work to be performed.
ix) Utilize the Assistants Properly.

3.3. Development of an Overall Plan - Overall plan is basically intended to provide direction for audit work programming and includes the determination of timing, manpower development and co-ordination of work with the client, other auditors and other experts. The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit.
i) Terms of his engagement and any statutory responsibilities.
ii) Nature and timing of reports or other communications.
iii) Applicable Legal or Statutory requirements.
iv) Accounting policies adopted by the clients and changes, if any, in those policies.
v) The effects of new accounting and auditing pronouncement on the audit.
vi) Identification of significant audit areas.
vii) Setting of materiality levels for the audit purpose.
viii) Conditions requiring special attention such as the possibility of material error or fraud or involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
ix) Degree of reliance to be placed on the accounting system and internal control.
x) Possible rotation of emphasis on specific audit areas.
xi) Nature and extent of audit evidence to be obtained.
xii) Work of the internal auditors and the extent of reliance on their work in the audit.
xiii) Involvement of other auditors in the audit of subsidiaries or branches of the client and involvement of experts.
xiv) Allocation of works to be undertaken between joint auditors and the procedures for its control and review.

xv) Establishing and coordinating staffing requirements.

3.4. Circumstances Where Audit Programme Would Have To Be Suitably Altered

i) If the audit procedures were designed for a certain **volume of turnover** and subsequently the volume have **substantially increased**.
ii) When there have been **significant changes** in the **accounting organization**, procedures and personnel subsequent to the audit procedures.
iii) Internal control procedures were **not as effective** as assumed at the time the audit programme was framed.
iv) Where there has been an **extraordinary increase** in the amount of **book debts.**
v) Where there has been an **extraordinary change** in the value of **stocks** as compared to that in the previous year.
vi) When a **suspicion** is aroused during the course of audit or information has been received that assets of the company have been misappropriated.

3.5. Knowledge About The Clients Business

i) The auditor must have the necessary knowledge about the client's business. This will **enable** him to **identify the events, transactions and practice** that may have a significant effect on the financial information.
a. The auditor of a **manufacturing concern** must understand the vital aspects of production process to the extent necessary for audit.
b. The auditor of a **banking or insurance company** must know the typical aspects and procedures of banking or Insurance business.
ii) The auditor must also know the **history** of the business, its managements, and organization etc. of the client's business.
iii) The auditor must know the various **places and locations** of business.
iv) The auditor must know the **products** manufactured and **services** rendered by the client

The auditor can obtain knowledge about the client business as follows,
i) Preliminary Knowledge (Before Accepting the Audit)
a. The client's **annual reports** to shareholder.
ii) Subsequent Knowledge (After Accepting the Audit)
a. Minutes of meeting of shareholders, Board of Directors.
b. Internal financial management **reports**, including budgets.
c. Previous year's audit working papers and other files.
d. Discussion with the client.
e. The client's **policy and procedural** manual.
f. Relevant **publications** of the Institute of chartered Accountants of India and other professional bodies, Industry publications, Trade Journals, Magazines, Newspapers etc.
g. Consideration of **state of economy** and its effect on client's business.
h. Visit to client's **premises and plant facilities**.

3.6. Designing An Audit Strategy

Audit strategy is concerned with designing **optimized audit approaches** that seek to achieve the necessary audit assurance at the lowest cost within the constraints of the information available. Audit strategy generally involves the following steps:
i) Obtaining knowledge of business - Understanding the business and using this information appropriately **assists** the auditor in:
a. Assessing risks and identifying problems.
b. Planning and performing the audit effectively and efficiently.
c. Evaluating audit evidence.
d. Providing better service to the client.

ii) Performing analytical procedure at Initial stages - The use of analytical procedures during the planning stage requires
a. the extensive use of **accounting and business knowledge** and
b. the experience to assess the potential for **material misstatement** in the financial statements as a whole, because the key aspect of the task is to identify the relevant risk indicators and to interpret them properly.
Analytical techniques applied during the planning stage are **not as precise** as the analytical techniques at the substantive stage.
iii) Evaluating inherent risk -
a. Inherent risk is a type of Audit risk which is uncontrollable and it depends upon the **scope of Audit**.
b. To assess inherent risk, the auditor would use **professional judgment** to evaluate numerous factors, having regard to his experience of the entity from **previous audit engagements** of the entity, any controls established by management to **compensate** for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment.
iv) Evaluating internal controls - The auditor needs an understanding of the accounting systems, regardless of whether the audit strategy will involve an extended assessment of internal accounting controls. This should be done by:
a. Documenting the extent to which the system is **computerized**.
b. Preparing or updating overview **flowcharts** to record the files and transactions relating to significant systems-derived account balances.

3.7. Formulating The Strategy - The auditor should develop the strategy by:
i) Considering the results of **gathering or updating** information about the client.
ii) Making **preliminary judgments** about materiality, inherent risk and control effectiveness.

CASE STUDIES

Q1. Designing an Audit Strategy is the backbone of the "Audit Planning" process. Discuss.
Hint Ans: Refer Point No. 3.6

Q2. Your firm is the auditor of HPCL Ltd. which operates 25 petrol stations in and around India. You are the senior in charge of the audit for the year ending 31st March, 20x9 and are engaged on the audit planning. Most of the company's sites are long-established and, as well as supplying fuel, oil, air and water, have car cash and a shop.
Over the last few years, due to the intense price competition in petrol retailing, the shops have been expanded into mini-markets with a wide range of motor accessories, food, drinks and household products. They also now sell National lottery tickets. Point-of-sale PCs are installed in all the petrol stations, linked on-line via a network to the computer at head office. Sales and inventory data are input direct from the PCs.
The company has an internal auditor, whose principal function is to monitor continuously and test the operation of internal controls throughout the organization. The internal auditor is also responsible for coordinating the yearend inventory count.
Requirements: Prepare notes for a planning meeting with the audit partner which
(i) Identify, from the situation outlined above, circumstances particular to HPCL Ltd. that should be taken into account when planning the audit, explaining clearly why these matters should be taken into account.
(ii) Describe the extent to which the work performed by the internal auditor may affect your planning, and the factors that could limit the use you may wish to make of his work.

Ans: (i)

Circumstances	Why taken into account
Multiple business locations.	Increases inherent risk (e.g. if the organisational structure is loose and difficult to manage)
Intense price competition.	May lead to uneconomic price discounting, possibly threatening viability of business
Recent expansion of outlets into minimarkets.	Increases complexity of business and may lead to loss of management control.
Perishable nature and limited shelf-life of food and drinks inventories	Increase risk of overstatement of inventory values.
Large volume of cash transactions	Increases risk of incomplete income recording.
Nature of the business (garage environment)	Increases risk of loss of inventories and cash due to theft or staff pilferage. May limit effectiveness of physical security controls (e.g. over access to terminals)
Recent introduction of sales of National Lottery tickets	Increases inherent risk (e.g. the risk of loss to HPCL Ltd. if incorrect amounts are paid out on winning tickets)
Direct input via PCs at branches	Increases risk of misstatement, as batch controls will not be feasible and scope for other input controls may be limited.
Small number of staff at each location (e.g. one or two)	Limits scope for segregation of duties within branches and therefore increases control risk.
Branch-based nature of business	Limits effectiveness of management control over activities of individual branches thereby increasing control risk
Use of part-time staff and high staff turnover	May inhibit effectiveness of controls within branches

(ii) Effect of work of internal auditor on audit planning

• The internal auditor's identification and documentation of areas of weakness will give direction to areas requiring increased substantive procedures.
• Work of the internal auditor may assist in selection of branches for audit visits, (e.g. where control failures have occurred).
• The internal auditor may attend yearend inventory counts at one or more branches, potentially reducing the number of branches to be visited by us.
• Work performed by the internal auditor may provide evidence to confirm operation of control procedures, on which we may seek to rely to reduce the extent of our own procedures.
• Documentation of systems and controls by the internal auditor, including changes due to the National Lottery, may reduce extent of our planning visits, as walk through checks may be sufficient to confirm systems documentation.

Q3. You are the manager responsible for the audit of Value Ltd. which has a year end of 31 March. This is the first year that your firm has undertaken the audit of Value Ltd., having succeeded the previous auditors at the last annuals general meeting following a successful tender for the audit. Your firm has an office in Mumbai and in 25 other location throughout the India.
You have had preliminary discussions with the management of Value Ltd. and obtained some background information about the company. The company produces fertilizer in a factory on the outskirts of Liverpool. The head office is situated in Mumbai. There are ten depots throughout the country which hold large stocks of fertilizer so that local demand for

its products can be met quickly. Inventory records are not maintained and a full count is carried out at the year end.
You have also read recent government press release that indicates that 'L', a product which forms a major part of the company's sales, contains a chemical that has been identified as being potentially dangerous to those who handle it. An official government working party has been set up to review the situation.
Requirement
(a) Identify the circumstances that should be taken into account when planning the audit of Value Ltd., and set out your outline audit approach in these areas.
(b) Explain the objectives of audit planning.
Ans: (a) Audit Planning

Circumstances	Outline audit approach
This is the first year that the firm has undertaken the audit of Value Ltd.	• In order to be satisfied about previous FS the auditor should: 1. Hold consultations with management 2. Review client's records, working papers and accounting and control procedures for the previous period 3. (Possibly) hold consultations with the previous auditor. 4. Be familiarizing with the nature of the business, market, accounting systems etc by discussions with management and by review of interim/management accounts.
Value Ltd. has • A head office in Mumbai • A factory in Liverpool • Ten depots throughout the country	• The staff must be planned to carry out the audit from the firm's offices throughout the country. • They must all be adequately briefed and provided with a copy of the audit plan detailing their specific tasks and deadlines.
No inventory records have been maintained but a full inventory count is to be carried out at the year end.	• It is very important that the auditors are satisfied with the inventory count. • The written count instruction must be reviewed well in advance of the year end, so that improvement can be suggested by the auditors and incorporated into the client's instructions. • The auditors should ensure that sufficient staff with the necessary experienced is available to attend the count at all material locations.
'L', a major product of the Company, has been identified as being potentially dangerous.	• Ascertain - For how long Value Ltd. has been selling 'L' and in what quantity? - How much 'L' the company now holds in inventory? • Ensure that the firm keeps up-to-date with the findings of the government working party. • Consider whether any of the employees of Value Ltd. may have been harmed and, if so, the consequential liability of the company to them

(b) Refer 3.1–(vi)

Q4. A&Co. was appointed as auditor of Great Airways Ltd. As the audit partner what factors shall be considered in the development of overall audit plan?
Hint Ans: Refer Point No. 3.3

Q5. You have been appointed as the auditor of a Multiplex Cinema House. Draw an audit programme in respect of its Revenue and Expenditure.
Ans: (i) Peruse the Memorandum of Association and Articles of Association of the entity.
(ii) Ensure the object clause permits the entity to engage in this type of business.

(iii) In the case of income from sale of tickets:
(1) Verify the control system as to how it is ensured that the collections on sale of tickets of various shows are properly accounted.
(2) Verify the system of relating to on line booking of various shows and the system of realization of money.
(3) Check that there is overall system of reconciliation of collections with the number of seats available for different shows on a day.
(iv) Verify the internal control system and its effectiveness relating to the income from cafes shops, pubs etc., located within the multiplex.
(v) Verify the system of control exercised relating to the income receivable from advertisements exhibited within the premises and inside the hall such as hoarding, banners, slides, short films etc.
(vi) Verify the system of collection from the parking areas in respect of the vehicles parked by the customers.
(vii) In the case of payment to the distributors verify the system of payment which may be either through out right payment or percentage of collection or a combination of both. Ensure at the time of settlement any payment of advance made to the distributor is also adjusted against the amount due.
(viii) Verify the system of payment of salaries and other benefits to the employees and ensure that statutory requirements are complied with.
(ix) Verify the payments effected in respect of the maintenance of the building and ensure the same is in order.

Q6. Amu & Co. was appointed as auditor of A Ltd. As the audit partner what are the points to be considered while evaluating "Knowledge of the Business" in the conduct of an audit?
Hint Ans: **Refer** Point No. 3.5

QUESTIONS

Q1. XYZ Ltd. appoints you as auditor of company. You observe that previous auditors A&Co. resigned. Also B/S as at 31-03-2010 shows an audit fee payable of Rs. 25,000. What precautions you will take before commencing the audit work? (4 Marks) **(Nov 2010)**

4. RISK ASSESSMENT AND INTERNAL CONTROL

4.1. Internal Control (IC) Structure In An Organization

The Internal Control (IC) structure means the **policies and procedures** established by the entity to provide reasonable assurance that the objectives are achieved. The IC structure in an organization basically has the following components:

i) Control Environment - Control environment **covers** the effect of various **factors like management attitude**; awareness and actions for establishing, enhancing or mitigating the effectiveness of specific policies and procedures.

ii) Accounting System - Accounting system **means** the series of task and records of an entity by which transactions are processed for maintaining **financial records**.

iii) Control policies & Procedure - Control Policies and procedures **means** those policies and procedures **in addition** to the control environment and accounting systems which the management has established to achieve the entity's specific objectives.

4.2 IC System - Nature, Scope, Objectives And Structure

i) Nature – The group of different **internally generated policies** and procedures adopted by the management of an entity is a **prerequisite** for an organizations efficient and effective performance.

ii) Scope – The different scopes of IC are as under -

a. IC **extends beyond mere accounting controls** and includes all administrative controls.
b. IC **helps in the decision - making** process leading to managements authorization of transaction.
c. IC **helps in primarily controls** relating to safeguarding of assets.
d. IC **helps in prevention** and detection of fraud and error,
e. IC **helps in accuracy** and completeness of accounting records and timely preparation of reliable financial information

iii) Objectives - The objectives of IC systems are determined by the management which are sought to be achieved are:

a. whether **all transactions** are **recorded**;
b. Whether recorded transactions are **real**;
c. whether all recorded transactions are **properly valued**;
d. whether all transactions are **recorded timely**;
e. whether all transactions are **properly posted**;
f. whether all transactions are **properly classified and disclosed**;
g. whether all transactions are **properly summarized**;

iv) Structure - In order to achieve the objectives of ICs, it is necessary to establish adequate control policies & procedures. Most of these policies & procedures cover:

a. Segregation of duties – Segregation of duties means **separating** the work to different persons. Transaction processing are allocated to different persons in such a manner that **no one** person **can carry** through the completion of a transaction **from start to finish** or the work of one person is made complimentary to the work of another person.

b. Adequacy of Records and Documents –Adequacy of records & documents **means** that records & documents must be **properly entered**. Accounting controls should ensure:

- **Transactions** are **executed** in accordance with management's **general or specific authorization**.
- Transactions and other events are **promptly recorded** at correct amounts.
- Transactions should be **classified** in appropriate accounts and in the appropriate period to which it relates.

• Recording of transaction should facilitate maintaining **accountability** for assets
• Assets and records are required to be **protected** from unauthorized access, use or disposition.

c. Accountability and Safeguarding of Assets – 'Accountability of assets' **means** proper accounting of assets from its acquisitions, use and final disposal. 'Safeguarding of assets' **means** proper maintenance of records and their periodic reconciliation with the related assets. Assets like cash, inventories, and investment scrips require frequent physical verification with book records.

d. Independent Checks – 'Independent checks' **means** verification by independent persons to ascertain whether the **control procedures** are operating effectively or not.

e. Authorization of Transaction – 'Authorization of transaction' **means Delegation of authority** to different levels **for controlling the execution** of transaction in accordance with prescribed conditions. Authorization may be general or it may be specific with reference to a single transaction.

4.3 Limitations Of IC: An IC system can provide **only reasonable assurance** that the management's objectives in establishing the system are achieved. The limitations may arise due to:

i) Management's consideration that the **cost** of an IC does not exceed the expected benefits to be derived.
ii) The **procedure** of IC may become **inadequate** due to changes in condition.
iii) Most ICs address transaction of usual and routine nature. They may be **failing** in respect of **transactions of unusual nature.**
iv) In any system of control, there is possibility of circumvention of ICs through **collusion** with employees and other persons might exist.
v) A member of the **management** may himself **override the controls.**
vi) Management itself may **manipulate** transactions or accounting estimates**.**
vii) The potential of **human error** such as carelessness, distraction, mistake and misunderstanding remains in any system of control.

4.4 Components Of ICs

i) Internal Check System – Internal check system **implies** organization of the overall system of book-keeping and arrangement of staff duties in such a way that **no one** person **can carry through a transaction and record every aspect** thereof. It is a part of overall control system and operates basically as a built-in-device as far as organization and job - allocation aspects of the controls are concerned.

ii) Objectives Of The Internal Check System

a. To **detect** error and frauds with ease.
b. To avoid and **minimize** the possibility of commission of errors and fraud by any staff.
c. To locate the **responsibility** area or the stages where actual fraud and error occurs.
d. To **increase the efficiency** of the staff working within the organization.
e. To prevent and avoid the **misappropriation or embezzlement** of cash and falsification of accounts.
f. To protect the **integrity** of the business by ensuring that accounts are always subject to proper scrutiny and check.

iii) The effectiveness of an efficient system of internal check depends on the following considerations -

a. Clarity of Responsibility - The **responsibility** of different persons engaged in various operations of business transactions should be **properly identified**.

b. Division of Work - The segregation of work should be made in such a manner that the free flow of work is not interrupted and also helps to determine that the work of one person

is **complementary** to the other. Then, it is suggested that **rotation** of different employees through various components of job should be effectively implemented.
c. Standardization - The entire process of accounting should be standardized **by creating suitable policies** commensurate with the **nature** of the business, so as to strengthen the system of internal check.
d. Appraisal - **Periodic review** should be made of the chain of operations and work flow. Such process may be carried out by preparing an **audit flow chart**.

iv) Internal Audit –
a. Internal audit may be defined as, an **independent appraisal function established** within an organization to examine and evaluate its activities as a service to the organization. The **scope** of the internal audit is determined by the management.
b. Internal auditing includes a **series of processes and techniques** through which an organizations **own employees ascertain** for the management, by means of on-the-job observation, whether established management **controls** are **adequate**, and are effectively maintained; records and reports financial, accounting and otherwise reflect actual operation and results accurately and properly; each division, department or other units are carrying out the plans, policies and procedures for which they are responsible.

4.5 Review Of The System Of ICs

The review of the IC system enables the auditor:
i) To formulate his **opinion** as to the reliance he may place on the system itself
ii) To locate areas of **weakness in the system** so that audit programme and nature, timing and extent of substantive and compliance procedures can be adjusted according to the weakness of the system.
iii) The auditor can also **suggest the management** about weakness in the system and possible ways to correct them.
The review of IC consists mainly of **enquiries of personnel** at various levels within the organization together with documentation relating to procedures, manuals, job description and flow charts to gain knowledge of controls, which the auditor has identified as significant to his audit.

4.6 Methods For The Proper Review And Evaluation Of The Adequacy Of The IC

i) Questionnaire (IC) –
a. It is a **set of questions** designed to provide a thorough view of the state of IC in an organization.
b. The questions are generally **prepared in sections** of distinct control areas and are often further segmented into subsections.
c. The most of the audit firms have developed their **own standardised Questionnaire**.
d. Weakness in IC can be known by examining the answers to the question in the questionnaire.
e. By this process the auditor would be better equipped to **decide extent and depth of checking required** in various accounting areas and can pursue his work more objectively.
f. The **management** of the concern under audit is normally expected to **put reply** against question in the questionnaire.
g. The **standard audit programme may be modified** in the light of knowledge gained by use of questionnaire.
h. The questionnaire helps the auditor to prepare a **report of deficiencies** and recommendations for improvement.

ii) Narrative record –
a. It contains a complete **written description** of the IC system of the enterprise as found in actual operation by the auditor.

b. The method of keeping a narrative record may be usefully employed in a **small business** where IC system may be generally weak.
c. The **type of extent** of narrative record will **vary** according to the **requirements** and individual judgment of each auditor.
d. This method may be recommended in cases where **no formal** control system is in operation.

iii) Check list –
a. A checklist is a **series of instruction** and/or question, which a member of the auditing staff must follow and I or answer.
b. When he completes the instruction, he initials the space against the instruction. Answers to the checklist instruction are usually **yes, no or not applicable**. This is again on job requirement and instructions are framed having regard to the desirable elements of control.
C. Different checklists may be prepared for **different clients and situation**.
Example -
a. Are purchases centralized in purchase department?
b. Are purchases I made only from approved suppliers?
c. Are purchases orders duly authorized?
d. Are purchases based on competitive quotations from two or more suppliers?

iv) Flow Charts –
a. Flow charts are a **graphic presentation** of the flow of documents through system or subsystem with installed check or control recorded on the lines of flow.
b. Flow charts are usually **prepared for such of the accounting system** which process **large volumes of transaction**, such as sales cycle, purchase cycle, and wages cycle.
c. Flow charts are widely and correctly regarded as very important **tool** in the evaluation of IC systems.
The evaluation of IC system with the help of flow chart can be done in the following manner.
a. Reviewing the flow charts themselves (looking for **inappropriate divisions** of duties or lack of automatic checks etc); and
b. Reviewing the flowchart by preparing an **IC check list**.

To begin with, in analyzing the flow charts **for IC** it is useful to ask with respect to **each step** in the system what would happen if this one step were **omitted or performed incorrectly**, either by accident or by intent? Would the omission or error be detected automatically by the system? If it would be detected, the IC is satisfactory. If not, it is weak.

Salient Features of an Ideal Flow Chart
a. at **what point a document is raised** internally or received from external sources;
b. the **number of copies** in which a document is raised or received;
c. the **intermediate stages** set sequentially through which the document & activity pass;
d. distribution of the documents to various section, department for operations;
e. checking authorization and matching at relevant stages;
f. filling of the documents; and
g. final disposal by sending out or destruction.

4.7 Compliance Procedures And Evaluation Of ICs
i) "Basic Principles Governing an Audit", states that, the auditor should obtain sufficient appropriate audit evidence through the performance of **compliance** and **substantive procedures** to enable him to draw reasonable conclusions there from on which to base his opinion on the financial information. According to it, compliance procedures are **tests**

designed to **obtain reasonable assurance** that those ICs on which audit reliance is to be placed are in effect. Obtaining audit evidence from compliance procedures is intended to reasonably assure the auditor in respect of the **following assertions**:
Existence - which the IC **exists**.
Effectiveness - which the IC is **operating effectively**.
Continuity - that the IC has so operated throughout the **period of intended reliance**.

ii) The auditor formulating his opinion on financial information needs reasonable assurance that **transactions** are **properly authorized and recorded** in the accounting records and that the transactions have not been omitted. ICs, even if fairly simple, may contribute to the reasonable assurance the auditor seeks. The **auditor's objective** in studying and evaluating ICs is to establish the reliance he can place thereon in determining the nature, timing and extent of his substantive auditing procedures.

iii) 'Compliance procedures' are **tested** designed to obtain reasonable assurance that those **ICs** on which audit reliance is to be placed are in **effect**. IC function effectively **throughout the period** of intended reliance. The concept of effective operation recognizes that some deviations from prescribed controls may have occurred.

iv) Based on the **results** of his compliance procedures, the auditor evaluates whether the ICs are **adequate** for his purpose. If based on the results of the compliance procedures, the auditor concludes that it is **not** appropriate to rely on a particular IC to the degree previously contemplated, he should ascertain whether there is **another control** which would satisfy his purpose and on which he might rely (after applying appropriate compliance procedures). Alternatively, he may **modify** the nature, timing or the extent of his substantive audit procedures.

4.8 IC and Risk Assessment
i) 'Control risk' is the **risk** which arises because of the **reliance placed** by an auditor on **IC** to **detect** material misstatements. **Assessment** of control risk is the **process of evaluation** of an organization's accounting and IC systems in **preventing and detecting material misstatements** in the financial statements. After understanding the accounting system and related ICs, the auditor should make a **preliminary assessment** of control risk for the relevant assertion in the financial statements. Such assessment also helps him in determining the nature, timing and extent of substantive procedures for such assertions.

ii) Relationship between the assessment of inherent risk and control risk:
a. Inherent risk is depending upon the **scope of audit** while Control risk is depending upon the reliance placed by an auditor on **IC**. In many cases, inherent risk and control risk are highly **interrelated**. Often, the accounting and IC system is designed to minimize inherent risk as well as to **prevent and detect** misstatements. Thus the auditor should make a combined assessment of the audit risks.
b. When both inherent and control risks are **assessed at a high level**, the auditor should also consider whether **substantive procedures** will provide **sufficient assurance** to reduce detection risk to an acceptable level. When the auditor determines that the detection risk cannot be reduced to an acceptable level, he should either **qualify or disclaim an opinion** or if this is not practicable, **withdraw** from the engagement.

4.9 IC in Small Business Enterprises - The auditor needs to obtain the **same degree of assurance** in order to give an unqualified opinion on the financial statements of both small and large enterprises. Many controls which would be relevant to large entities are **not practicable** in small business. **For example**, in a small business segregation of related functions is to a minimum extent. However, such weakness may be offset by proper

supervisory role performed by the owner. In cases where segregation of duties is lacking or inadequate supervisory role is performed by the owner, the auditor will have to rely on substantive procedures.

4.10 Internal Audit - Many large organizations have system of internal audit within the organization as an **integral part** of the **IC**. They have separate internal audit department. 'Internal audit' is the **review of various operations** of the company and its records by staff specifically appointed for this purpose. This **review** may be **periodical or** may be even **continuous**.

The scope of internal auditor's work is briefly discussed below -

i) Review of IC system and procedures:

a. The internal auditor should determine whether the IC system is in **consonance** with the **organizational structure**.

b. The control system should be **cost effective**.

c. The internal auditor should ensure that the controls were **operational and effective** throughout the **period of reliance**.

ii) Review of organizational structure - The auditor should conduct an appraisal of the organization structure to ascertain whether it is in **harmony with the objectives** of the organization. In this regard he should ensure that

a. There is parity between **authority and responsibility** given to managers;

b. There is no **duplication** of activities;

c. A **balanced span of control** for executives has been designed;

d. The system identifies and ensures imparting of required **training** to managers.

iii) Review of relevance and reliability of information - The internal auditor should review the information system to evaluate the reliability and relevance of financial and operating information given to management and external agencies such as government bodies, trade organizations etc.

iv) Review of utilization of resources - The internal auditor should ensure that proper **operating standards are established** for measuring economical and efficient use of resources. The system should enable identification of responsibility and should be capable of being used for monitoring and evaluating performance.

v) Review of compliance with plans, policies, procedures and regulations –

a. The internal auditor should examine whether the management has a system by which its policies, plans and procedures are **properly communicated** to all concerned.

b. The Internal auditor should review the manner in which policies and plans are **formulated** by the management and suggest remedial actions.

vi) Review of accomplishment of goals and objectives - The internal auditor should ensure that all **key managers participate** in determining the overall goals of the organization. He should evaluate whether these goals are clearly stated and attainable.

vii) Review of custodianship and safeguarding of assets - The internal auditor should ensure that the system ensures that all assets are accounted fully and are adequately **protected against losses**.

CASE STUDIES

Q1. You are the senior auditor in charge of the audit of Bianca Ltd., a manufacturing company. You have been talking with the payroll supervisor who has commented on the strength of the company's payroll internal control system. She has assumed that this internal control system guarantees the completeness, accuracy and validity of the payroll accounting records. Requirements:
(a) State whether you agree with the supervisor's assumption that an internal control system can guarantee the completeness, accuracy and validity of the records, supporting your answer by using examples from a payroll system.
(b) The supervisor has also asked you to explain some internal control terminology which she does not understand. Explain the meaning of the following terms, using payroll examples different from chose you have given above.
(i) Segregation of duties
(ii) Approval and control of documents
Ans: (a) Objectives and limitations - Due to inherent limitations (including human error/ misunderstanding, collusion and override), an internal control system can only provide reasonable confidence that internal control objectives (including completeness, accuracy and validity) are met.
(i) Completeness - To ensure that all workers who should be paid are included on the payroll:
> Payroll expense could be reconciled to production output records, and
> Management could review exception reports of employees having personnel records but not included on the payroll.
However, **Cost/benefit** i.e. the expense of setting up computerised personnel records may outweigh the benefit to the company. (Risk is of over payment as employees entitled to pay are likely to bring non-payment to management's attention promptly)
Changes in conditions - A reduction in the ratio or production to support staff may limit the usefulness of production output records as a basis of comparison.
(ii) Accuracy - To prevent errors in payroll deductions:
> Calculations of PAYE, NICs etc. can be checked prior to processing and Non-statutory deductions (e.g. pension contributions, union subscriptions) should require prior authorisation in writing.
However, **Human error/misunderstanding** i.e. errors in deductions may not be detected, due to fatigue, distraction, misjudgment or misinterpretation.
Non-routing transactions - Systematic checking procedure may be directed at routing deductions (e.g. PAYE) rather than non-routing transactions) e.g. give as you earn, maintenance payments)
(iii) Validity - To ensure that employee are only paid for work done
> Hours worked per time sheets (or clock cards) can be approved by a departmental manager (or-supervisor), and
> The duties of payroll preparation and payment should be segregated.
However, Abuse or override i.e. authorisation could be given for a new employee to be added to the payroll without the proper checks being carried out by the authoriser.
Collusion - The person responsible for paying wages could collude with the person responsible for accounting for wages to perpetrate and conceal a theft of wages.

(b) (i) Refer Point No. 4.2-iv-(a)
(ii) Refer Point No. 4.2-iv-(b)

Q2. Bhawan Ltd. is a retailer of fashion accessories. It has a turnover of Rs. 54 million and 150 shops throughout the India. It also has six regional warehouses from which the shops are supplied with goods. The company has an internal audit department which is based at

the company's head office in Delhi. Internal auditors make regular visits to the shops and warehouses. This is the first year that your firm has acted as auditor for Bhawan Ltd. The partner in charge of the audit has expressed his opinion that the internal audit department might be able to assist the external audit team in carrying out its work. Requirements:
(a) State, with reasons, the information that you would require to make an assessment of the likely effectiveness and the relevance of the internal audit function.
(b) Describe four typical procedures that might be carried out by the internal auditors during their visits to the shops and warehouses and on which you might wish to rely.
(c) Assuming that you intend to rely on the work of the internal audit department of Bhawan Ltd., describe briefly the effect this will have on your audit of company's FS.
Ans: (a)

Information	Reason
Organizational status & reporting responsibilities of the internal auditor and any constraints and restrictions thereon	Degree of objectivity is increased when internal audit: - is free to plan and carry out its work and communicate fully with the external auditor - has access to the highest level of management.
Areas of responsibility assigned by management to internal audit, such as review of - Accounting systems and IC - Implementation of plans	Not all areas in which internal audit may operate will be relevant to the external auditor. - (Relevant) - (Not relevant)
Routine tasks carried out by internal audit staff such as authorization of petty cash reimbursements.	In these respects staff are not functioning as internal audit, they are working simply as an IC.
Internal auditor's formal terms of reference	Internal auditor's role will be most relevant where it: - Has a bearing on the FS. - Involves a specialization
Internal audit documentation such as an audit manual and audit plan	It is more likely that due professional scare is being exercised where the work of internal audit is properly planned, controlled, recorded and reviewed.
Professional membership and practical experience of internal audit staff.	Unless internal audit is technically competent it is inappropriate to place reliance on it.
Internal audit reports generated and feedback thereon.	How the company responds to internal audit findings may be regarded as a measure of the department's effectiveness.
Number of staff, computer facilities and any other resources available to internal audit.	Effectiveness of internal audit (and hence the reliance placed thereon) will be limited if the department is under- resourced.

(b) Typical procedures
(i) Inspection of tangible non-current assets: Assets seen at the warehouses (e.g. delivery vehicle fleet) should be noted and subsequently agreed to the fixed asset register maintained at head office (HO). Assets recorded in the register (e.g. shop fixtures and fittings) should be selected for inspection prior to visits to ensure their existence.
(ii) Attendance at inventory counts: Periodic counts (e.g. monthly) should be attended on a rotational basis at warehouses and larger shops to ensure adherence to the company's procedures. Test counts should be made to confirm the accuracy and completeness of the inventory counts
(iii) Cash: Cash counts should be carried out on each register takings (and petty cash floats) whenever shops (and warehouses) are visited on a 'surprise' basis.

(iv) Goods dispatch: IC procedures should be observed to be in operation, for example to ensure that all dispatches are documented and destined for the company's retail outlets.
(v) Employee verification: Payroll procedures are likely to be carried out at HO, warehouses and shops informing HO on a weekly basis of hours worked by employees, illness and holiday etc. However, new employees, especially in the shops (and probably also in the warehouses) will be recruited locally and their details notified to HO.
Internal audit will be able to select a sample of employees from HO records and ensure on the visits to shops and warehouses' that these represent bonafide employees.

(c) Effect on audit
(i) Systems documentation: The accuracy of systems documentation which has been prepared by internal audit need only be confirmer using 'walk-through tests'. This saves time (if the systems documentation is correct) since only copies will be required for the audit file.
(ii) Tests of controls: The level of independent testing (i.e. by the external auditor) can be reduced where controls have been satisfactorily tested by internal audit, especially if error rates are found to be similar. In particular, attendance at stocktaking at the yearend may be limited to those locations with the highest stockholdings.
(iii) Substantive procedures: Internal audit's evidence (e.g. concerning the existence of tangible non-concern assets), will reduce sample sizes for yearend verification work. Substantive procedures may also be reduced where the internal audit checks reconciliations' (e.g. of supplier's statements to ledger balances, receivable and payables control accounts and bank reconciliations.)

QUESTIONS

Q1. Explain briefly the Flow Chart technique for evaluation of the IC system. (4 Marks) **(Nov 2009)**

Q2. (a) As auditor of Z Ltd., you would like to limit your examination of account balance tests. What are the control objectives you would like the accounting control system to achieve to suit your purpose? (4 Marks) **(May 2010)**
(b) In the audit planning process of X Ltd., you would like to consider audit risk at the FS level. What are the factors can influence your decision? (3 Marks) **(May 2010)**

5. AUDIT UNDER COMPUTERISED INFORMATION SYSTEM (CIS) ENVIRONMENT

5.1 Scope Of Audit In A CIS Environment - Impact of computerization on audit approach needs consideration of the following factors:
i) High speed - Complex reports in **specific report format** can be generated for audit purposes without much loss of time. This cut down time enables the auditor to extend their **analytical review** for under coverage with high speed of operation, the auditor can expand their **substantive procedures** for collection of more evidence in support of their judgment.

ii) Low clerical error - Computerized operation being a systematic and sequential programmed course of action the **chances of commission of error** is considerably reduced. **Clerical error** is highly minimized.

iii) Concentration of duties - As computer programs **perform more than one set of activities** at a time thereby concentrating the duties of several personnel involved in work.

iv) Shifting of Internal control base -
a. Application systems development control - Systems development control should be designed to provide **reasonable assurance** that they are **developed** in an authorized and efficient manner, to establish control, over:
- **Testing,** conversion, implementation, and documentation of new revised system.
- **Changes** to application system.
- **Access to** system documentation.
- **Acquisition** of application system from third parties.

b. Systems software control - Systems software controls are designed to provide reasonable assurance that system software is **acquired or developed** in an authorized and efficient manner including:
- **Authorization**, approval testing, implementation and documentation of new system software systems software modifications.
- Putting **restriction of access** to system software and document to authorized personnel.

v) Disappearance of manual reasonableness – Many stages which are required under manual operations are either **deleted** or managed to create a focused computer system for creating logical models under a CIS system, in such creative effort, the manual reasonableness may be missing.

vi) Impact of poor system - If system analysis and designs falls short of expected standard of performance, a computerized information system environment may do more harm to integrated business operation than good.

vii) Exception reporting - The **value of a variable is only reported** if it lies outside some pre-determined normal range. This is a part of Management information system

viii) Man-machine interface / human-computer interaction – "Human-computer interaction" is a **discipline** concerned with the design, evaluation and implementation of interactive computing systems for human use and with the study of the major phenomena, surrounding them. Man-machine interface ensures **maximum effectiveness** of the information system.

5.2 Audit Approach In CIS Environment
i) Black-Box Approach i.e., Auditing Around The Computer - In the Black box approach or Auditing around the computer, the Auditor **concentrates on input and**

output and **ignores** the specifics of **how computer process** the data or transactions. If input matches the output, He assumes that processing of data must have been correct.
Advantage: It has ease of comprehension as the tracing of documents to output does not require any in-depth study of application program.
Disadvantage: He does **not** have directly **tested the control**, cannot make **assertions** about the underlying process. In some of the more complex computer systems **intermediate printout** may not be available for making the needed comparisons.

ii) White-Box Approach i.e., Auditing Through The computer –
a. The processes and controls surrounding the subject are not only subject to audit but also the **processing controls** operating over this process are investigated.
b. Computer **Audit software** may be used to help him to gain access to these processes.
c. Auditor needs to have sufficient **knowledge of computers** to plan, direct-supervise and review the work performed.
d. The auditor will need to be satisfied that there are **adequate controls** over the prevention of unauthorized access to the computer and the computerized database.

5.3 Types of Computer Systems

i) Systems Configuration

a. Large system computers - In large system computers, the **processing task** of multiple users is performed **on a single centralized computer**, i.e., all inputs move directly from the terminal to central processors after processing goes back to users.
b. Standalone personal computers - A stand alone system is one that is **not connected** to or does not communicate **with another** computer system. All input data and its processing takes place on the machine itself.
c. Network computing system - A network is a **group of interconnected system** sharing services and interacting by a shared communication links. All networks have something to share, a transmission medium and rules for communication. Network shares hardware and software resources. Hardware resources include:
• **Client Server** - A server in a network dedicated to perform specific tasks to support other computers on the network.
• **File Server** - File servers are the network applications that store, retrieve and move data.
• **Data base server** - Most of the data base are client server based. Database servers provide a powerful facility to process data.
• **Message Server** - They provide a variety of communication methods which takes the form of graphics. Digitized audio/video etc.
• **Print Server** - Print server manages print services on the network.
d. Electronic Data Interchange (EDI) -
•EDI is the computer to computer **exchange of inter-company** business documents in a public standard format
• EDI **eliminates** the need to re-enter data into the accounting system.
• This results in **fewer errors** and more **timely** information.
• These systems also require proper **controls** over input of transactions.

ii) Processing System

a. Batch Processing - Here the transactions are **accumulated** and processed in a **group**. For e.g. cash receipts may be processed at an interval of an hour.
b. Online Processing System – It refers to **processing** of individual transactions as they occur from their **point of origin** as opposed to accumulating them into batches.
c. Interactive Processing - Under this processing mode, a **continuous dialogue** exists between the user and the computer. It is also called 'transaction driven' processing as transactions dealt with completely on an individual basis through all the relevant processing operations before dealing with the next transaction occur and enquiries to be dealt with on

an immediate response basis.
d. Online Real Time Processing - In this system **transactions are entered as they occur** and are **processed as** they are **entered**.
e. Time Sharing - Where a computer **serves more than one person**, there occurs time sharing.
f. Service Bureau - Here an **outside entity** is hired to process the transactions of the business.

→ **Decision Support System** – A "Decision Support System" (DSS) can be defined as a system that provides tools to managers in solving **semi-structured and unstructured problem.** A Decision-Support System has 4 basic components:
• **The Users -** represent **managers** at any given level of authority in the organization.
• **Data bases -** contains both **routine and non-routine data** from both internal and external sources.
• **Planning Language -** include general purpose planning language **like** spread sheets/special purpose planning languages, SAS, SPSS, Minilab etc;
• **Model Base -** It is the **'Brain'** of the DSS as it perform **data manipulations and computations** with the data provided by the user and data base.

→ **Expert System -** An "Expert System" is a computerized information system that **allows non experts to make decision** comparable to that of an expert. Expert systems are used for complex or ill structured tasks that require experience and special knowledge in specific subject areas. As expert system typically contains:
• **Knowledge Base** - This **includes** data, knowledge, relationships, rules of thumb to and **decision rules** used by experts to solve a particular type of problem.
• **Inference Engine -** This program contain the **logic and reasoning mechanisms** that stimulate the expert system logic process and deliver advice.
• **Use interface -** This program allows the user to design, create, update, use and **communicate** with the expert system.
• **Explanation Facility -** This facility provides the user with an explanation of the **logic** the expert system use to arrive.
• **Knowledge acquisition Facility -** Building a knowledge base (also called knowledge engineering), involves both a **human expert and a knowledge engineer.**

g) Integrated File System - These systems **update many files simultaneously** as transaction is processed. Integrated data base system contains a set of interrelated master files that are integrated in order to reduce data redundancy.

5.4 Effect Of Computers On Internal Controls - In a CIS environment, the following **problems** arise in the implementation of internal controls:
i) Separation of duties - In a manual system, separate individuals are responsible for initiating transactions, recording transactions and custody of assets. **Due to automation** in the system, such controls are **not possible** in a computer system.

ii) Delegation of Authority and responsibility - Due to use of resources by **multiple users**, it becomes difficult to delegate authority and responsibility in a precise manner. For example, as many users access the database, it may not be possible to trace the person making unauthorized changes in it.

iii) Competent and Trustworthy persons - Organizations find it **difficult to find and retain** competent and trustworthy personnel to take charge of their EDP set up.

iv) System of authorization - As against the manual system, automation of the authorization procedure is an important feature of EDP System. For example, the computer system may determine the price to be charged to customers. Thus the auditor has to **verify** the **veracity of computer processing**.

v) Adequate documents & records - In computer systems, documents may not be used to support the initiation, execution and recording of some transactions. Thus, **no visible audit trail** may be available.

vi) Physical control over assets and records - As the data processing assets and records are **concentrated at place**, the risk of loss and unauthorized access is high.

vii) Adequate management supervision - In computer systems, data communications may be used to enable the employees to be closer to the customer they service. Thus **supervision** of employees may have to be carried out **remotely**.

viii) Independent checks on performance - Checks by an independent person help to **detect** any **errors** or irregularities.

ix) Comparing recorded accountability with assets - If **unauthorized modifications** occur to the program or the data files that the computer program uses, an irregularity might not be discovered, because traditional separation of duties no longer applies to the data being prepared for comparison purposes.

5.5 Effect Of Computers On Auditing - Auditor must provide a competent, independent opinion as to whether the financial statements records and report a **true and fair view** of the state of affairs of an entity. The **objective** of auditing, do **not undergo a sea change** in a CIS environment. However, computer systems have affected how auditor's need to collect and evaluate evidence. These aspects are discussed below:

i) Changes to Evidence Collection - Auditors have to face a diverse and complex range of internal control technology that did not exist in manual system. Collecting evidence on the reliability of a computer system is often **more complex than** collecting evidence on the reliability of a manual system.

ii) Changes to Evidence Evaluation - With increasing complexity of computer systems and control technology, it is becoming more and more **difficult to evaluate the consequences** of strength and weaknesses of overall reliability on the system

5.6. Major Types Of Internal Controls In A Computer System - **Major types of controls** used to enhance component reliability which auditor must evaluate are:
i) Authenticity Control: They are exercised to verify the identity of the individuals or process involved in a system. (Pass word, digital signature etc.)
ii) Accuracy Control: These attempts to ensure the correctness of the data and processes in a system (Programme validation check).
iii) Completeness Control: This ensures that no data is missing and all processing is carried through to its proper conclusion.
iv) Privacy Control: This ensures the protection of data from inadvertent or unauthorised disclosure.
v) Audit Trail Controls: This ensures the traceability of all events occurred in a system.
vi) Redundancy Control: It ensures that processing of data is done only once.
vii) Existence Control: It attempts to ensure the ongoing availability of all system resources.

viii) Asset safeguarding controls: It attempts to ensure that all resources within a system are protected from destruction or corruption.
ix) Effectiveness Control: It attempts to ensure that the system achieves its goals.
x) Efficiency Control: It attempts to ensure that a system uses minimum resources to achieve its goals.

5.7 Internal Control Requirement Under CIS Environment - The requirement of IC under CIS environment may cover the following aspects:
i) Organization and Management Controls
a. Designing policies and procedures relating to control functions.
b. Segregation of incompatible functions.

ii) System Software Controls
a. Restricted access of software to authorised personnel only.
b. Authorization, approval, testing and implementation of new software.

iii) Application System Development and Maintenance Controls
a. Restricted Access to system documentation.
b. Changes to application systems should be authorised.
c. Acquisition of application systems from third parties should be carefully planned.
d. Testing and implementation of new systems in a proper way.

iv) Computer Operation Controls
a. Use of only authorized programs on computers.
b. Only authorised personnel should use computer.
c. Systems should be used for authorised purpose.
d. Processing errors are detected and corrected on a timely basis.

v) Data Entry and Program Controls
a. Restricted access to data and programs to authorised personnel only.
b. Input should go through an authorization process.

vi) Controls over input - To check whether:
a. Input is duly authorised.
b. Data input is accurate.
c. Transactions are not lost or altered.
d. Incorrect transactions are rejected or submitted after correction.

vii) Controls over Processing and computer data files - To check whether:
a. Processing errors are detected and corrected on a timely basis.
b. Transactions are properly processed by the computer.

viii) Controls over Output - To check whether:
a. Results of processing are accurate.
b. Access to output is restricted to authorized personnel.
c. Output is provided to appropriate authorized personal on a timely basis.

5.8 Approaches To Auditing In A CIS Environment
The approach to auditing in a CIS environment provides for the following:
i) Skill and Competence - An auditor should have sufficient knowledge of the computer information systems. The **sufficiency** of knowledge would depend on the nature and extent of the CIS environment. The auditor should consider whether any **specialized CIS skills**

are needed in the conduct of the audit. If the answer is in affirmative the auditor would seek the assistance of an **expert** possessing such skills.

ii) Planning - To plan an audit, understanding about organization structure, significance of computer processing, complexity, availability of data source documents, files, etc. should be considered.

iii) Risk - When the computer information systems are significant the auditor should assess whether it may influence the **assessment of inherent and control risks**. The nature of the risks and the ICS in CIS environment include the following:
a. Lack of Transaction Trails
b. Uniform processing of Transactions
c. Lack of Segregation of functions
d. Potential for errors and Irregularities
e. Initiation or Execution of Transactions
f. Dependence of Other Controls over Computer Processing
g. Increased management Supervision
h. Use of Computer - Assisted Audit Techniques

iv) Risk Assessment - The auditor in accordance with SA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment" should make an assessment of inherent and control risk for material financial statement assertions. He should consider the **following for risk assessment**:
a. Own application / packages (If client uses packages, it is Less Risky)
b. Industrial environment (If other Co. in same industry are also using CIS - Less Risky)
c. Pervasive CIS controls (If CIS controls are present, then Less Risky)
d. Access to specific function (If restricted for some authorised personnel only, Less Risky)
e. Ability to change and develop the report (If restricted, Less Risky)
f. Documentation (If available, Less Risky)
g. Factors affecting quality of evidence (paperless office is generally More Risky).
h. Specific risk (Electronic funds transfers are More Risky)
i. End-user computing (More Risky due to Less Internal Controls)
j. Lack of time, discipline or knowledge to monitor results of processing (High Risk)

v) Documentation - In an audit in CIS environment, some of the audit evidence may be in electronic form. The auditor should satisfy himself that such evidence is **adequately and safely stored** and is retrievable in its entirety as and when required.

vi) Knowledge of Business - Entity's attitude towards I.T., usage should be compared with industry, special attention is given to recent and planned changes.

5.9 Review of Checks and Controls in a CIS Environment

Review process of general controls in a CIS environment can be categorized as under:
i) Organization Structure/Control - CIS function in an organization need to be so organized that **different groups** are formed to perform **different duties** in a large CIS installation. Some of the typical function that must be performed by select group includes:
a. Data Administrator - Generates the data requirements of the users of information system services, formulates data policies, plans the evaluation of the corporate databases and maintains data documentation.
b. Database Administrator - Responsible for the operational efficiency of corporate database, assist users to use database better.
c. System Analyst - Manages information requirement for new and existing applications,

designs information systems architectures to meet these requirements, facilitates implementation of information systems, write procedures and users documentation.
d. System Programmers - Maintains and enhances operating systems software, network software, library and utility software, provides when unusual systems failure occurs.
e. Application Programmer - Designs programs to meet information requirements, codes, tests and debugs programs documents programs, modify program to remove errors, improve efficiency.
f. Operation Specialist - Plans and control day to day operations monitors and improves operational efficiency along with capacity planning.
g. Librarian - Maintains library of magnetic media and documentation.

ii) Documentation Control - Systems and programs as well as **modifications**, must be adequately documented and properly approved before being used. Adequate documentation evidencing approval of changes minimizes the probability of unauthorized system and program changes that could result in loss of control & decreased reliability of financial data.

iii) Access Control - Access controls are usually **aimed** at for **preventing unauthorized access.** The controls may seek to prevent persons who are authorized for access from accessing restricted data and program, as well as preventing unauthorized persons from gaining access to the system as a whole.
a. Segregation Controls – Access to program documentation should be limited to those persons who require it in the performance of their duties.
b. Limited Physical Access to the computer Facility - The physical facilities that hold the computer equipment, files and documentation should have controls to limit access only to **authorized individuals**.
c. Visitor entry Logs - Entry logs should be used to determine and documents those who have had access to the area.
d. Hardware and Software access controls - Access control software like 'user identification' maybe used. User identification is a frequently used control and is a **combination of** unique identification **code and a password**.
e. Call back - It is a specialized form of **user identification** in which the user dials the system, identifies him and is disconnected from the system. Then, either an Individual manually finds the authorized telephone number or the system automatically finds the authorized telephone number of the individual and finally the user is called back.
f. Encryption - In encryption **data is encoded** when stored in computer files and or before transmission to or from remote locations. This coding protects data because to use the data unauthorized users must not only obtain access, but must also **decrypt** the data i.e., decode it from encoded form.
g. Computer Application Controls - Programmed application control to specific application rather than multiple applications.

iv) Input Controls - Input into the CIS system should be properly authorized and approved. The system should **verify** all significant **data fields** used to record information i.e., Should perform editing of the data. Conversion of data into machine readable form should be controlled and verified for accuracy. For validation of input controls, the following procedure can be applied:
a. Pre-printed form - All constant information be printed on a source document.
b. Check Digit - A Check Digit is a **redundant digit(s) added to a code** that enables the accuracy of other characters in the code to be checked. The check digit can act as a **prefix or suffix character** or it can be placed somewhere in the **middle** of the code. When the code is entered, a program recalculates the check digit to determine whether the entered check digit and the calculated check digit are the same. Errors made in transcribing and keying data can have serious consequences. One control used is a 'Check Digit'.

c. Completeness Totals - To input data erroneously is one type error. To leave out or lose data completely is another type of error against which controls are provided.
• **Batch Control Totals** - The transactions are collected together in batches of say, 50 transactions. A total of all the data value of some important field is made.
• **Batch Hash Totals** – The idea is similar to control totals except that Hash totals are meaningless totals prepared purely for control purposes.
• **Batch Record Totals -** Account is taken of the number of transactions and this is compared with the record count produced by the computer at the end of the batch.
• **Sequence Checks** - Documents may be pre-numbered sequentially before entry and at a later computer will perform a sequence check and display any missing number.
d. Reasonableness Checks - These are sophisticated **forms** of **limit checks**. An **example** might be a check on an electricity meter reading. The check might consists of subtracting the last reading recorded from the current reading and comparing this with the average usage for that quarter. If the reading differs by a given percentage then it is investigated before processing.
e. Field Checks - The **following types** of field cheeks may be applied:
• **Missing data/blank** - Is there any missing data in the field? If a code should contain 2 hyphens, though they might be in a variable position, can only one be detected? Does the field contain blanks when data always should be present?
• **Alphabetic/Numeric -** Does a field that should contain only alphabetic or numeric contain alphanumeric characters?
• **Range -** Does the data for a field fall within its allowable value range?
• **Master Reference -** If the master file can be referenced at the same time input data is read, is there a master file match for the key field?
• **Size -** If variable - length fields are used and a set of permissible sizes is defined does the field delimiter show the field to be one of these valid sizes?
• **Format Mask -** Data entered into a field might have to conform to a particular format,
f. Record Checks - The following types of record checks can be applied:
• **Reasonableness -** Even though a field value might pass a range check, the contents of another field might determine what a reasonable value for the field is.
• **Valid-Sign-Numeric -** The content of one field might determine which sign is valid for a numeric field.
• **Size** - If Variable - length records are used, the size of the record is a function of the sizes of the variable length fields or the sizes of fields that optionally might be omitted from the record. The permissible size of the fixed and variable - length records also might depend on a field indicating the record type.
• **File Checks** - In file checks, validation control examines whether the characteristics of a file used during data entry are matching with the stated characteristics of the file.

v) Processing Controls - Almost all of the controls mentioned under input may also be incorporated during processing stage. Processing validation checks primarily ensure that computation performed on **numeric fields are authorized**, accurate and complete. Processing controls are essential to ensure the integrity of data. When input has been accepted by the computer, it usually is processed through multiple steps. The following validation checks may be indicated in this regard.
a. Overflow - Overflow can occur if a field used for computation is not initiated to zero at start. Some error in computation occurs, or unexpected high values occur.
b. Range - An allowable value range can apply to a field.
c. Sign Test - The contents of one record type field might determine which sign is valid for a numeric field.
d. Cross - Footing - Separate control totals can be developed for related fields and cross footed at the end of a run.
e. Run-to-Run Control - In a tape based system, the processing of transaction tile may

involve several runs, for instance, a tape based order processing system might have a transaction tape that is used to update first a stock master file, then a sales ledger followed by a general ledger, various control totals may be passed from one run to the next as a check on completeness of processing.

f. Recording Control - Recording controls enable records to be kept free of errors and transactions details that are input into the system.

• **Error Log -** This is particularly important in **batch entry and batch processing system**. Many of the accuracy checks can only be carried to during run time processing. It is important that a detected error does not bring the run to a halt, on discovery, the erroneous transaction is written to an error log file, which is examined at the end of processing. The errors can then be corrected or investigated with the relevant department before being input and processed.

• **Transaction Log -** The transaction log provides **record of all transactions** entered into the system as well as storing **transaction details** such as the transaction reference number, the date the account number, the type of transaction the amount and the debit and credit references. The transaction will be "Stamped" with details of input. These typically include input time, input date, input day, terminal number and user number. It is used for multi-access main frame systems accounting transactions. The transaction log can form the basis of an audit trail and may be printed out for investigation during an audit.

g. Storage Control - These controls **ensure** the accurate and continuing and **reliable storage of data**. Data is a vital resource for an organization and is the heart of CIS activities. Special care must be taken to ensure the integrity of the database or file system. The controls are particularly accidental erasure of files and the precision at back-up and recovery facilities. The **following checks** may be considered:

• **Physical Protection against Erasure** - Magnetic tape files have **rings** that may be inserted if the files are to be written or erased. Read only files have the ring removed

• **External Label** - These are **attached** to tape reels or disk packs **to identify** the content.

• **Magnetic Labels** - These **consists** of magnetic **machine readable information** coded on the storage medium identifying its contents. File header labels appear at the start of a file and identify the file by name, give the date of last update and other information. This is checked by software prior to file up dating. Trailer labels at the end of files often contain controls that are checked against those calculated during file processing.

• **File Back - up Routines** - Copies are held of important files for **security purposes**. As the process of providing back-up often involves a computer operation in which one file is used to produce another, a fault in this process would have disastrous results; if both the master and the back-up were lost.

• **Database Back - up routines** - The **contents** of a data base held on a direct access storage device (DASD) such as magnetic disk are periodically **dumped** on to a **back-up**. The back-up is usually a tape which is then stored together with the transaction log tape of all transactions occurring between the last and the current dump.

• **Cryptographic Storage** - Data is commonly written to files in a way that uses **standard coding** like ASCII or EBCDIC. It can be interpreted easily by unauthorized reader gaining access to the file. If data is confidential & sensitive then it may be scrambled prior to storage and described on reading.

viii) Output Control - Output control ensures that the **results of data processing are accurate**, complete and are directed to authorize recipient. The auditor should examine whether **audit trail** relating to output was provided and the date and time when the output was so provided. This would enable the auditor to identify the consequences of any errors discovered in the output.

5.10 Auditors Involvement In The Clients System Development & Documentation Control - Auditors both external and internal may be consulted while designing appropriate

controls over the development of computerized system within an enterprise. Such association may help in suggesting appropriate trails in post implementation audit.
The Methodology involves:
i) Identification of the system (setting system boundary), the system objectives, the system components, and
ii) Understanding the role and **inter-relationships of elements** with other elements of the same system.

a. System Development Life Cycle Stage

- Stages and Objectives → Deliverable output
- Systems Investigation and Feasibility Report → Feasibility Report.
- System Analysis → Logical Model of the System
- System Design → A Detailed Physical Specification of The System.
- Implementation → The New System with Documentation Procedure
- Changeover → The New System With Documentation Procedure
- Evaluation and Maintenance → Evaluation Report.

b. The benefits of this staged approach are:

- **Sub-division** of a complex, lengthy project into discrete chunks of time, makes the project more manageable and thereby promotes better project control.
- Although different parts of a project may develop independently during a stage, the parts of the project reach the same point of development at the end of the stage. This promotes **coordination** between the various components of large projects.
- The deliverables being documentation provide a **historical trace of the development** of the project. At the end of each stage the output documentation provides an initial input into the subsequent stage.
- The document deliverables are designed to be **communication tools** between analyst, programmers, users and management.
- The stages are designed to the `**natural' division points** in the development of the project.
- The stage allows a **creeping** commitment to **expenditure** during the project.

c. Project Stages

- **Determination of Scope and Objective** - Before an analyst can attempt to undertake a reasonable systems investigation, analysis and design, there must be some indication given of the agreed overall scope of the project. The documentation provided on this acts as the **analysts initial terms of reference**.
- **System Investigation and Feasibility Study** - The output of this stage is a report on the **feasibility of a technical solution** to the problems or opportunities mentioned in the statement of scope and objectives in stage A. The solution will be present in broad outlines.
- **System Analysis** - Provided that the project has been given the go ahead as a result of the feasibility study, the next task for the analyst is to build a **logical model** of the existing system. This will be partly based on information gathered from the existing system during the stage of system investigation and partly on new information.
- **System Design -** Once the analysis is complete the analyst has a good idea of what is logically required of the new system. There will be a number of ways that this logical model can be incorporated into a **physical design**.
- **Implementation -** During implementations the system as specified is **physically created**. The hardware is purchased and installed. The programs are written and tested individually. The database or file structure is created and historic data from the old system is loaded.
- **Changeover** - Changeover is **that time** during which the **old system is replaced** by the newly designed computer system. This period may be short if, at the time the new system starts, running the old system is discarded. **Alternative method** of changeover exists.

• **Evaluation and Maintenance** - At this time, the system is running and in continual system use. It should be delivering the benefit for which it was designed and installed. The maintenance will involve hardware and software.

5.11 Computer Assisted Audit Techniques (CAATs) - The **overall objectives and scope** of an audit **do not change** when an audit is conducted in a CIS environment. The application of auditing procedures may, however, require the auditor to consider techniques known as CAATs that use the computer as an audit tool for enhancing the effectiveness and efficiency of audit procedures. **"CAATs"** are **computer programs and data** that the auditor uses as part of the audit procedures to process data of audit significance, contained in an entity's information systems.

i) Steps in application of CAATs
a. Setting objective of CAAT.
b. Content and accessibility of entity's files.
c. Transaction type to be tested.
d. Procedure to be performed on data.
e. Define output requirement
f. Personnel.
g. Refine cost and benefits estimates.
h. Ensure documentation of CAAT use.
i. Arrange administrative activities.
j. Execute CAAT application.
k. Evaluate the results

ii) Uses of CAATs - CAAT are used to perform various Audit Procedures like -
a. Tests of Details of transactions and balances e.g. use of Audit software to test all / few transactions in a computer file.
b. Analytical Review Procedures e.g. use of Audit software to identify unusual fluctuations or unusual items.
c. Compliance Test of **General IT Controls** e.g. use of test data to test access procedures.
d. Compliance Test of **IT Application Controls** e.g. use of test data to test the functioning of a programmed procedure.
e. Re-performing calculations performed by entity's accounting system.
f. Sampling programs to select data for testing.

iii) Audit Software -
a. These are **computer programs** used by auditor to process data from the entity's accounting system.
b. However, Auditor should use such programs only after he proves their validity for Audit purposes.
c. Audit Software may be of three types:
• **Package Programs** are **generalized computer programs** designed to perform data processing functions, such as reading data, selecting and analyzing information, performing calculations, creating data files and reporting in a format specified by the auditor.
• **Purpose-Written Programs perform audit tasks** in **specific circumstances**. These programs may be **developed by** the auditor, the entity being audited or an outside programmer hired by the auditor. In some cases, the auditor may use an entity's existing programs in their original or modified state because it may be more efficient than developing independent programs.
• **Utility Programs** are used by an entity to perform **common data processing functions**, such as sorting, creating and printing files. These programs are generally not designed for audit purposes, and therefore may not contain features such as automatic

record counts or control totals.
• **System Management Programs** are **enhanced productivity tools** that are typically part of a sophisticated operating systems environment, for example, data retrieval software or code comparison software. As with utility programs these tools are not specifically designed for auditing use and their use requires additional care.

iv) Advantages and Disadvantages of Computer Audit Programs -
a. Advantages:
• **Examining data faster** and more accurately than clerical audit test;
• providing the **only practical method** of checking large amounts of data; and
• **Continue to be used** until the file layouts are changed.
b. Disadvantages:
• **Technical Skill** and experience are required in developing a program;
• **Greater knowledge** of the system is required than for conventional test;
• the **program** needs to be **amended** for any change iii system; and
• **Difficulties** may be experienced in obtaining adequate computer time for testing.

v) Considerations in the use of CAATS - In determining whether to use CAATs, the **following factors** should be considered:
a. Computer Knowledge, Expertise and Experience of the Auditor - The audit team should have **sufficient knowledge** to plan, execute & use the results of particular CAAT,
b. Availability OF CAATs and Suitable Computer Facilities - The auditor may **plan to use other computer facilities** when the use of CAATs is impractical. The **cooperation** of the entity's personnel may be required, for example to assist with activities such as loading and running of CAAT on the entity's system.
c. Impracticability of Manual Tests - Many computer information systems perform tasks for which **no hard copy evidence** is available, making it impracticable for the auditor to perform tests manually.
d. Effectiveness and Efficiency - CAATs are often an **efficient means of testing** a large number of transactions. In evaluating the effectiveness and efficiency of CAAT, the auditor considers the continuing use of CAAT application.
e. Timing - Certain data are often kept for a short time and may not be available in **machine-readable form** by the time auditor wants them. Thus, he needs to make arrangements for the retention of data required.
f. Controlling the CAATs Application – Control of Software Applications
• Participate in the design and testing of the computer programmes.
• Check the coding of program.
• Review operating system instructions to ensure compatibility of software with client's files.
• Testing of audit software should be done before loading client's data into it.
• Ensure use of correct files.
• He should arrange for proper vendor support.
• He should take appropriate security measures to maintain integrity of software
g. Documentation - The auditor should maintain sufficient working papers containing **detailed description** about CAATs with regard to the plans, their execution, audit evidence obtained, etc. He would be wise to document **suggestions** for using CAATs in future years.

CASE STUDIES

Q1. Briefly discuss the type of internal control required under computer based system?
Hint Ans: Refer Point No. 5.7

Q2. "Computers affect the implementation of the internal controls". Discuss the problems arises in implementation of internal control in CIS Environment.

Hint Ans: **Refer** Point No. 5.4

Q3. "The method of collecting audit evidence and evaluating the same changes drastically under CIS Environment" Comment on the above.
Hint Ans: **Refer** Point No. 5.5

Q4. T & Co which has recently invested in CAAT software wishes to apply the same in the audit of a large public limited company. List the planning activities involved in use of CAAT.
Hint Ans: **Refer** Point No. 5.11 (i)

Q5. "The auditor must evaluate major clauses of control used in a Computerised Information system to enhance its reliability" – Comment.
Hint Ans: **Refer** Point No. 5.6

QUESTIONS

Q1. The auditor must evaluate major clauses of control used in a CIS to enhance its reliability – Comment. (8 Marks) **(Nov 2008)**

Q2. The role of an auditor in collecting audit evidences under EDP system is more complex than under the manual system - Discuss. (8 Marks) **(Nov 2009)**

Q3. Different types of controls which operate over date moving into, through and out of the Computer. Auditor is required to review such control. Comment (8 Marks) **(Nov 2010)**

Q4. Z Ltd. has its entire operations including accounting computerized. As the audit partner you are concerned about inherent and control risk for material FS assertions. What could be the areas you look forward for deficiencies and risk identification? (4 Marks) **(May 2011)**

6. THE COMPANY AUDIT

6.1 Qualification and Disqualification of Auditors

i) Qualification -

a. Nationality of person is not important.
b. A **CA** holding a certificate of practice or a Firm of CA.
c. A **holder of certificate** in 'Part B' State entitling him to act as an auditor

ii) Disqualification - The following persons shall not be qualified for appointment as auditors of a company:

a. A **body corporate**
b. An **officer or employee** of the company
c. A person **who is a partner, or who is in the employment,** of an officer or employee of the company
d. A person **who is indebted** to the company for an amount exceeding one thousand rupees, or who has **given any guarantee** or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees. Indebtedness of up to Rs. 1000 would not be a disqualification.
e. A person **holding any security** of the company which carries **voting rights**.
f. A person who by virtue of any of the aforesaid provisions is disqualified for appointment as an auditor in the company's **subsidiary or holding** company, or a subsidiary of that company's holding company.
g. A partnership firm, wherein any partner is disqualified by virtue of any of the provisions.

6.2 Vacation Of Office

i) An auditor, who after his appointment **becomes subject to any of the above disqualifications,** shall be deemed to have vacated his office as an auditor.
ii) According to Clause IV of Part I of second schedule of the **Chartered Accountants Act**, a professional and practicing CA shall be guilty of a professional misconduct, if he expresses his opinion on the FS of any enterprise, in which he or his firm or a partner in his firm or any of his relatives have a **substantial interest**.

6.3 Appointment Of Auditors

i) Appointment of First Auditor [Sec 224(5)]

a. The Board of Directors **(BOD)** will appoint the first auditors **in one month** of the date of registration of the company and **shall hold office until** the conclusion of the **first** AGM.
b. In case the Board does not exercise/fails to exercise its power in this regard, the **shareholders in its general meeting** shall appoint the first auditors.
c. The auditors of a newly formed company **cannot** be appointed through MOA & AOA.
d. The first auditor is also not required to **inform the Registrar** about his acceptance or refusal of the said appointment.

ii) Appointment by Company i.e. Shareholders [Sec 224(1)]

a. Except in case of first auditor, every company shall, at **each AGM,** appoint an auditor.
b. The Appointment is made through **Ordinary Resolution**
c. He shall **hold office** from **conclusion** of that meeting until the conclusion of **next** AGM.
d. The company shall give **notice of appointment** or reappointment to the auditor within 7 days of the appointment or reappointment.
e. The auditor shall give notice to the **registrar** within 30 days of receipt of notice of appointment or reappointment from the company.
f. The notice to ROC shall state as to whether he has **accepted or refused** the appointment.

iii) Reappointment of Retiring Auditor:

a. According to Section 224(2), at any **general meeting**, a retiring auditor, by whatsoever authority appointed, shall be reappointed.

Exceptions:

• He is **disqualified** for reappointment.
• He has given the company a **notice in writing of his unwillingness** to be reappointed.
• A **resolution** has been passed at the meeting appointing somebody else instead of him or providing expressly that he shall not be reappointed; or
• Where **notice** has been given of an **intended resolution** to appoint some person or persons in place of a retiring auditor, and by reason of death, incapacity or disqualification of that person or of all persons, as the case may be, the resolution cannot be proceeded with.

b. If the next **AGM is not held** within the period prescribed by Section 166, the auditor(s) shall continue to hold office till such meeting is held and concluded as the appointment is valid only from the conclusion of one meeting **up to the conclusion** of the next meeting. Where such meeting is **adjourned** to a later date, the auditor(s) shall hold office till the conclusion of the adjourned meeting.

iv) Appointment by Central Government [Sec 224(3)]

a. Where at any general meeting, **no auditors** are appointed or reappointed **within 7 days** of such a meeting, the **company shall intimate** this information to the CG who may appoint a person to fill the vacancy.

b. If the **company fails to give intimation** to the CG, the company and every officer in default, shall be punishable with a fine which may extend to **Rs. 5000**.

Examples: **No auditor appointed:**

• Where the appointment of a person appointed as an auditor in an AGM is void ab initio.
• Where OR is passed, but the appointment of auditors requires SR.

v) Appointment in case of Casual Vacancy [Sec 224(6)]

'A casual vacancy' **means** a vacancy arising in the office of an auditor before the expiry of his term in normal course. In common sense, it means vacancy in the office of auditor resulting from accidental or fortuitous circumstances such as death, incapacity or disqualification of the auditor.

a. Where a vacancy is caused by the **resignation** of an auditor before the expiry of his term in normal course the vacancy shall only be filled by the **share holders in GM**.

b. Where a vacancy of an auditor is caused by the way **other than resignation** before the expiry of his term in normal course the vacancy shall be filled by the **Board**.

c. Till the time a casual vacancy continues, the **remaining auditor** or auditors (i.e., the other joint auditors), if any, may act.

d. Any auditor appointed in casual vacancy shall hold office until conclusion of **next AGM.**

vi) Appointment by Special Resolution (Sec 224 A)

a. In case of a company in which **not less than 25%** of the **subscribed share capital** is held, whether singly or in any combination, by - • CG; • Any SG; • A Govt. Co.; • A Public Financial Institution; • Any Financial or other Institution established by any provincial or State Act, in which a SG holds not less than 51% of the subscribed share capital, • A Nationalized Bank; • An Insurance Company carrying on general insurance business.
The appointment or reappointment of an auditor or auditors shall be made by a special resolution at each general meeting of the company.

b. If the company **fails to pass** such a special resolution for making the appointment of an auditor or auditors, it shall be **deemed that the auditor or auditors had not been appointed** by the company at its AGM. The Company shall give Notice of that fact to CG **within 7 days of conclusion of AGM**. In such a case, **the CG may appoint a person to**

act as the auditor of the company.

vii) Appointment by Comptroller and Auditor General (C&AG) of India
a. Appointment of Auditors of Government Companies (Sec 619)
• Appointment of auditors in case of a Govt. company is subject to the provisions of Sec 619 which overrides Sec 224 to Sec 233 dealing with appointment, etc., of the auditors in the case of non-government companies.
• The auditor of a Govt. Company shall be appointed or reappointed by the **C&AG**.
c. The appointment shall be subject to **ceiling limits** as per sec 224 (IB) and (IC).
b. In case a company in which not less than 51% of the Paid up share capital is held, whether singly or jointly by -
• The CG and one or more Government companies;
• The SG or Governments and one or more Government companies.
• The CG, one or more SG and one or more Government companies.
• The CG and one or more corporations owned or controlled by the CG;
• The CG, one or more SG and one or more corporations owned or controlled by CG.
• One or more corporations owned or controlled by the CG or the SG, and
• More than one Government company
The auditors shall be appointed by the C&AG (section 619)

6.4 Ceiling On Number Of Audits [Sec 224 (IB)]
i) See 224(IB) states that an auditor cannot hold the audit of companies in excess of the "specified number" of **twenty companies,** out of which not more than **ten companies** shall have a paid-up capital of rupees twenty-five lakhs or more.
ii) In the case of a **firm** of Chartered Accountants having two or more partners, the specified number shall be counted per partner of the firm. Example, If there are three partners, the firm can hold the audit of 60 companies of which not more than 30 companies shall have a paid-up capital of Rs. 25 lakhs or more.
iii) When one person is a **partner in more than one firm** that person shall be considered only once for the ceiling purposes. Just because he is in more than one firm, he will not be considered more than once. He can hold twenty audits in aggregate.

Audits Excluded:
Following audits shall not be included while computing 'specified number':
i) Audit of a private company.
ii) An audit of a guarantee company having no share capital.
iii) An audit of a foreign company.
iv) An internal audit.
v) Audit of cooperative societies, trusts and corporations.
vi) Tax audits under Income Tax Act, 1961
vii) Special audit and investigations.
viii) Audit of Branch.
ix) Special audits.
x) Audits of non-corporate bodies

Audits Included: Following audits shall be included while computing 'specified number':
i) Joint Audit.
ii) An audit of a company licensed u/s 25.

ICAI Notification
• Limit is 30 including private companies.
• Maximum 10 public companies should be whose paid up capital > Rs. 25 lakhs
• Even a branch audit will be included but appointment should be under section 228

Overall Limits

	As per Companies Act	As per C.A. Act	Applicable
Accepting only Public Co.'s Audits	20	30	20
Accepting only Pvt. Co.'s Audit	Unlimited	30	30

6.5 Auditor's Remuneration [Sec 224(8)]

i) Meaning of Remuneration:

a. Any sum paid by the company in respect of the auditors' expenses shall be deemed to be included in the expression 'remuneration'.
b. Out-of-pocket-expenses of the auditors shall be included in the remuneration unless resolution fixing remuneration specifically provides that expenses shall be paid separately.
c. Remuneration for other services is permissible as agreed with management without sanction of shareholders. However, disclosure in P&L A/c is required.

ii) Right to fix Remuneration:

Appointment Made by	Remuneration fixed By
Members/Shareholders/Company	Members/Shareholders/Company in GM
Board	Board
Central Government	Central Government
C&AG	Members/Shareholders/Company in GM

iii) Disclosure of Remuneration in Final Account:

The P&L A/c shall contain or give by way of a note, a detailed information in regard to the amount paid to the auditor, whether as fees, expenses or otherwise for services rendered.
a. as auditor
b. as advisor or in any capacity in respect of: Taxation matters; Company Law Matters; and Management Services;
c. in any other manner.

6.6 Steps To Be Taken By The Auditor Before Accepting The Appointment

i) Issuing a **certificate** that on appointment by the company, the **limit on holding** of company audit as contemplated under section 224(IB) will not be exceeded.

ii) Ensuring that the requirements of the **Section 224 and 225** of the Companies Act have been **complied** with as discussed below:
a. If the appointment of the auditor is made for the first time after the incorporation of the company, the auditor should **verify** whether the **BOD** has **passed resolution** for his appointment **within one month** of date of registration of company.
b. If the BOD has not appointed the first auditor but the appointment is made by the company in **GM**, the auditor should **verify** as to whether a **proper notice** convening the GM has been issued by the company and whether the resolution has been **validly passed** at the GM of the company.
c. If the appointment is being made to fill a **causal vacancy** the incoming auditor should **verify** whether the **BOD have power** to fill causal vacancy and whether BOD have passed the resolution filling the causal vacancy.
d. If the vacancy has a risen due to **resignation** of auditor, the incoming auditor should see as to whether a **proper resolution** filling the vacancy has been passed at the **GM**.
e. If vacancy has arisen as a result of **removal** of the auditor before the expiry of his term of office, the incoming auditor should see that the proper resolution has been obtained.
f. If the provision of Section 224 A (Appointment by Special Resolution) apply to the company, the incoming auditor should **verify** as to whether a **special resolution** as required under the said Section has been passed.

g. Where auditor **other than the retiring auditor** is proposed to be appointed, incoming auditor should ascertain whether the provision of Section 225 have been complied with.

iii) Communication with the pervious auditor.

6.7 Removal Of Auditor

i) Removal of First Auditor before expiry of his term (i.e., before the 1st AGM) (Sec. 224(5))]

a. Ordinary Resolution shall be passed at a General Meeting.
b. No special notice is required for such removal.
c. Procedure prescribed u/s 225(2) and (3) shall be followed.
d. Any other person may be appointed in his place of whose nomination a **notice** has been given to the members not less than 14 days before the date of the meeting.

ii) Removal of subsequent auditor before expiry of his term (i.e., before the AGM) [Sec. 224(7)]

a. Previous approval of Central Government is required.
b. Ordinary Resolution shall be passed at a General Meeting.
c. No special notice is required for such removal.
d. Procedure prescribed u/s 225(2) and (3) shall be followed.

iii) Removal of auditor (whether first auditor or subsequent auditor) at an AGM (Sec. 225)

a. Previous approval of CG is not required.
b. Ordinary Resolution shall be passed at a General Meeting.
c. Special notice is required for such removal.
d. Procedure prescribed u/s 225(2) and (3) shall be followed.
Special notice may require that –
• The retiring auditor shall not be reappointed; or
• Some person, other than retiring auditor, shall be appointed as an auditor.

iv) Removal by CG (Sec. 408)

a. When can CG exercise its powers u/s 408? - Where appointment of nominee directors is made u/s 408 to end the oppression or mismanagement.
b. Nature of powers of CG
• Amongst other powers, CG has power to give directions to the company u/s 408.
• The directions may include a direction to remove the existing auditor.
• The directions given by CG shall come into effect as if all the provisions of the Act in this behalf have been complied with.
c. Effect of direction of CG - The existing auditor shall **vacate office** without requiring any action for his removal.

v) In other cases:

a. Any auditor may be removed from office before expiry of his term. But this can be done by the **general meeting** after obtaining **prior approval of the CG** in this behalf.
b. In the case of the removal of an auditor before the expiry of his term, some provisions of Section 225 relating to the right of the auditor to make representations, to get the representation circulated among shareholders and the right of being orally heard at GM.

6.8 Appointment Of A New Auditor In Place Of Retiring Auditor

i) According to section 225(1), a **special notice** is required for a **resolution** at an AGM appointing as an auditor a person other than a retiring auditor. A special notice is also required for a resolution providing expressly that a retiring auditor shall not be reappointed.
ii) On receipt of such a special notice, the company shall send its **copy** to retiring auditor.

iii) The retiring auditor, on receipt of a copy of such special notice, may make **representations** in writing to the company. He may also request the company to circulate his representations to the members of the company. The company must **circulate such representations to the members**.
iv) A **notice of the resolution** should be given to the members stating also the fact of representations having been made. If a copy of the representation is not sent to the shareholders because they were received too later or because of the default of the company, the auditor may require that the representation shall be **read out** at the meeting.
v) If the **CLB** on application either of the company or of any person claiming to be aggrieved, is satisfied that this right has been abused to secured needless publicity for defamatory purposed, copies of representations need not be sent out/read out at meeting.
vi) These provisions shall also apply to the **removal of first auditors** appointed by BOD.
vii) When a **new auditor** is appointed in place of the retiring auditor, the company within **seven days** of the meeting should intimate to the new auditor about his appointment who in turn should inform the Registrar within **one month** of the receipt of the intimation, in writing that he has accepted or refused to accept appointment.
viii) The **new auditor** should **communicate** in writing to retiring auditor before accepting the audit. If auditor accept a position as an auditor previously held by another CA, without first communicating with him in writing amounts to **breach of professional etiquette**

6.9 Rights And Powers Of An Auditor

i) Right of access to books, accounts and vouchers [Sec 227(1)1] - The auditor has the **absolute** right to access, **at all times**, to books and accounts and vouchers of the company, whether kept at **head-office or elsewhere,** without any restriction.

ii) Right to obtain information and explanations [Sec 227(1)] - An auditor of the company is entitled to **require from the officers** of the company such information and explanation as he may think necessary for the **performance of his duties** as an auditor.

iii) Right to visit branch offices and access to branch account [Sec 228(2)] -
a. Where the accounts of any branch office are **audited by a person other than the company's auditor**, the company's auditor is entitled to visit the branches.
b. The Auditor has also a right of access of all the **books and accounts** and vouchers of the company maintained at the branch office at all times.
c. The auditor does **not** have right to visit **foreign branches** of a banking company.
d. The company auditor has also right to **receive the audit report** from branch auditor.

iv) Right to receive notice and attend general meetings [Sec 231] -
a. The auditor has the right of receiving all **the notices** and other communications relating to any general meeting of a company which any member of the company is entitled to have.
b. He is entitled to **attend any general meeting** and to be heard at any general meeting which he attends oh any part of the business which concerns him as an auditor.

v) Right to make representation [Sec 225] -
a. The retiring auditor is entitled to receive a **copy of the special notice** intending to remove him or proposing to appoint any other person as auditor.
b. The retiring auditor sought to be removed has a right to make his **representation in writing** and request that the same be circulated amongst the members of the company.
c. The representation could not be circulated; the auditor may require that the same shall be **read out** at the general meeting.
d. The auditor also has the right to be **heard at the general meeting**.

vi) Right to report to members [Sec 227(2)] -
a. The auditor has right as well as duty to make a report to the members on the **accounts examined** by him.
b. The auditor has right to give **opinion** on the information and explanation given to him.
c. The auditor is not required to send his report to **every member**.

vii) Right to sign audit report [Sec 229] -
a. The auditor has a right as well as duty to sign the **audit report** and B/S & P/L Account
b. The auditor has also a right as well as duty to sign all the **documents attached** or annexed therewith.

viii) Right to seeking opinion of an expert -
a. In respect of any **special technical matters**, the auditor is entitled to consult and take the opinion of an expert.
b. The auditor is also entitled to take **legal advice** so as to discharge his duties efficiently.

ix) Right to receive remuneration [Sec 224(8)] -
a. The auditor has an inherent right to **receive** remunerations for auditing accounts of Co.
b. This right **accrues** only after he has completed the work.

x) Right to retained documents
a. The auditor has a right to retain the books which must **belong to the company**
b. Documents must have come into possession of auditor with the **authority of the Board**.

6.10 Duties Of Company Auditors
i) Report to Members [Sec 227(2)] — The auditor is required to make a report to the members of the company —
a. On the **accounts examined** by him;
b. On the **Balance Sheet and the Profit and Loss Account**; and
c. On every **other document** declared by the Companies Act to be part of, or annexed to the Balance Sheet and Profit and Loss Account;

ii) Examination of accounts [Sec 227 (3)] - The auditor has to state in his report -
a. Whether he has obtained all the **information and explanations** which to the best of his knowledge and belief were necessary for the purpose of audit;
b. Whether in his opinion, **proper books of accounts**, as required by the law, have been kept by the company and proper returns adequate for the purposes of audit have been received from the branches not visited by him.
c. Whether the report on the accounts of any **branch office audited** under Section 228 by a person other than the company's auditor, has been forwarded to him and how he has dealt with the same in preparing the auditor's report; and
d. Whether the company's **Balance Sheet** and Profit and Loss Account dealt with by the report are in **agreement** with the books of account and returns;
e. Whether, in his opinion, the Profit and Loss account and Balance Sheet comply with the **accounting standards** referred to in subsection (3C) of section 211.
f. Whether any **director** is **disqualified** from being appointed as director U/S 274(i) (g).
g. Whether any cess or **tax payable** under section 441 A has been paid and if not, the details thereof.

iii) Reporting On True And Fair View -
The primary duty of auditor is to express his opinion whether the B/S shows a true & fair view. Before expressing his opinion on the truth and fairness of FS, the auditor must see:
a. That they are drawn up according to exact **legal requirements**;

b. That they show the **financial position** and profit floss without any distortion;
c. That they do not contain any **misstatement** as to income or expenses;
d. That the GAAP have consistently been followed in drawing up the FS; and
e. All **necessary information** is made available to shareholders as to the true financial position of the company.

iv) Duty As To Enquiry [Sec 227 (IA)] - It is the duty of the auditor to inquire
a. Whether **loans and advances** made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interest of the company or its members;
b. Whether **transactions** of the company which are represented merely **by book entries** are not prejudicial to the interests of the company;
c. Where the company is an **investment company or a banking company**, whether so many of the assets of the company as consists of shares, debentures and other securities have been sold at a price less than at which they were purchased by the company;
d. Whether **loans and advances**, made by the company have been shown as **deposits**;
e. Whether **personal expenses** have been charged to revenue account; and
f. Whether it is stated in the books and papers of the company that any shares have been **allotted for cash**, whether the cash has actually been so received, whether the position as stated in the accounts books and the Balance Sheet is correct, regular and not misleading.
The auditor is **not required to report** on the matters specified under this section unless he has any **special comments** to make on any of the items referred to therein, If he is satisfied as a result on the enquiries, he is not required to report that he is so satisfied.

v) Report As To Additional Matters [Sec 227 (4A)] -
a. Under Section 227 (4A), the Central Government has power to direct, by means of a **general or special order**, that in case of companies specified in the order, the auditor's report shall also include a statement on such matters as may be specified therein.
b. In exercise of this power, the Central Government has issued **Companies (Auditor's Report) order CARO, 2003**.
The order supplements the existing provisions regarding the auditor's report in case of specified companies. The auditor has to make a **statement** on each of the matters specified in the order.

vi) Duty To Sign Report [Sec 229] -
a. It is the duty of auditor to sign the **auditor's report** or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor.
b. In case of a firm, only a partner of the firm **practicing in India** can sign the report.

vii) Duty as to Statutory Report [Sec 165(4)] - It is duty of the auditor to certify as correct that part of the Statutory Report that relates to:
a. The **shares allotted** by the company;
b. Cash received in respect of such share; and
c. Receipts and payments of the company.

viii) Duty as to Prospectus [Section 56] - Section 56 deals with matters to be stated and the reports that are to be set out in the prospectus.
a. Prospectus is issued by an **existing company** contains a statement of profits and losses for the **last five year**.
b. Prospectus is showing the **rate of dividends** paid each year
c. Prospectus is showing the **assets and liabilities** of company.

d. Prospectus may also indicate the nature of **provisions and adjustments** made or to be made. It is the duty of the auditor to certify these reports for the purposes of prospectus.

ix) Duty To Assist Investigation [Section 240] - Where an inspector is appointed under Sec 235 or 237 investigate the affairs of the company, it is the duty of the auditor -
a. To **preserve and to produce** to the inspector, all books and papers of, or relating to, the company (or any other body corporate) which are in his custody or power; and
b. Otherwise to give to the inspector all **assistance** in the connection with the investigation which he is reasonably able to give?

x) Duty To Give Reasons For Qualifications
a. The manner in which qualifications are made in the auditor's report should be such as not to leave any room for **doubt in the minds** of the public. A qualification should give full information and not merely create grounds for suspicion of enquiry.
b. The auditor should quantify, wherever possible, the effect of the qualifications on the financial statements, if the same is **material**.
c. Where it is not possible to precisely quantify the effect of the qualification, he may use **management estimates** or may state reason for not quantifying effect of qualification.

6.11 Scope Of Duties Of An Auditor - The scope of duties of an auditor depends upon nature of the business carried on by the concern, provisions of the law governing the organization and the system of the internal control in operation. The duties and responsibilities can be briefly summarized as follows:
i) To verify that the statements of account are drawn up on the basis of the books of the business. The auditor is **not liable** for **facts** which are **concealed and kept out of books** which he cannot verify in the ordinary course of exercise of reasonable care and diligence.
ii) To verify that the statements of account drawn up on the basis of the books **exhibit a true and fair state of affairs** of the business. The auditor must find out that, the statement of accounts are substantially correct, having regard to the provisions in the AOA and the Statue governing the business of the organization under which it is carried on.
iii) To confirm that the management has **not exceeded the financial administrative power** vested in it by AOA or by any specific resolution of shareholders passed at GM.
iv) To investigate matters in regard to which his **suspicion** is aroused as to the result of a certain action on the part of the servants of the company.
v) To perform his duties by exercising reasonable skill and care. He should **not** rely on the **certificate of the management** for those items which he can verify directly.

6.12 The Auditor's Lien - A 'lien' is the **right** of one person to satisfy a claim against another by holding the other's property as security or by **seizing** and converting the property under the procedures provided by law. An auditor can exercise lien on books & documents placed at his possession by the client for nonpayment of fees, for work done on the books and documents. Auditor can exercise his lien subject to **following conditions**:
i) Documents retained must **belong to the client** who owes the money.
ii) Documents must have **come into possession** of the auditor on the **authority of the client**. They must not have been received through irregular or illegal means.
iii) He can retain the documents only if he has **done work** on documents assigned to him.
iv) The documents which are **connected with the work** and on which fees have not been paid can be retained by the auditor.

Books of accounts can be handled over to the auditor after passing the **Board Resolution** and giving **notice to the Registrar**. In such circumstances, the auditor can exercise the right of lien for nonpayment of fees. However, the auditor must provide reasonable facility for **inspection** of the books of accounts by the directors and others

authorized to inspect under the Act.
The **working papers** are the property of the auditor **(SA 230 – Audit Documentation)**. Hence, the question of lien on them does not arise. However, the auditor at his discretion make portion of or extracts from his working papers available to his clients.

6.13 Audit Of Branches - As per the provisions of Sec 228 of the Companies Act, 1956, a company should get the accounts of its branches audited by **independent professional auditors**. Accordingly, a branch has been defined as -
i) Any establishment described as **branch** by the company; or
ii) Any establishment carrying on the same or substantially the **same activity** as that carried on by the head office of the company; or
iii) Any establishment engaged in any **production, processing or manufacturing**.

Exemption of branches from audit - A branch of a company carrying an manufacturing, processing or trading activity accounting for **average quantum** of activity not exceeding-
i) Rs 2 lakhs; or
ii) 2% of the average total turnover of the company.
Higher of the above shall be exempt from purview of compulsory audit of branch accounts.

Note that
i) Quantum of activity shall mean the **highest** of the following
a. The aggregate value of the goods and articles produced, processed or **manufactured**, or
b. The aggregate value of goods or articles **sold** or services rendered or
c. The amount of expenditure, whether of a revenue or capital nature, **incurred** by the branch office during the financial year
ii) Average quantum of activity shall mean the average of quantum of activity for **three years immediately preceding years** or such shorter period for which the company has been in existence.
iii) The CG also possesses discretionary powers to **exempt branches** from audit requirements in certain specific cases.

Branch Auditors

i) Who Can Be Appointed As Branch Auditors -
a. The company auditor **as appointed u/s 224**; or
b. Any other auditor **possessing qualifications** specified in section 226; or
c. In case of **foreign branches**, any of the above or an accountant qualified to act as auditor in that foreign country.

ii) Appointment Of Branch Auditors –
a. Appointment may be made by the members in **GM**
b. Alternatively; the shareholders may **authorize** the **Board** to make the appointment of branch auditor in consultation with company's auditor.

iii) Remuneration Of Branch Auditors –
a. Their remuneration shall be fixed by the members in **GM**.
b. Alternatively, the shareholders may **authorize** the **Board** to fix the remuneration of branch auditor.

iv) Powers Of Branch Auditors –
a. Branch auditors have all the powers in respect of the branch **as the company auditor** has in relation to company account.
b. He has **no right** to attend general meeting or to receive notice thereof.

v) Report Of Branch Auditor –
a. Report shall be prepared in accordance with **Sec. 227**.
b. Report shall be prepared in accordance with **CARO**.
c. Report shall be forwarded to the **company's auditor**.
d. The company's auditor, while preparing his **report**, shall deal with the report of the branch auditor in such manner as he deems fit.

Company's Auditor In Relation To Branch Audit -
i) The company auditor has full freedom to decide the prima facie **relevance and impact** of the branch audit report on the total company accounts.
ii) He has the right to **visit the branch**.
iii) In case certain **qualifications** are made in the branch audit report, the company auditor should exercise his judgment to decide whether the qualifications are significant enough to be stated in the consolidated report.
iv) He has the right of access at all times to the **books, accounts and vouchers** of the company maintained at the branch office.

6.14 Special Audit (Sec. 233A)

i) Circumstances In Which Special Audit May Be Ordered - CG is of an opinion that:
a. The affairs of the company are not being managed in accordance with **sound business** principles or prudent commercial practices; or
b. The company is being managed in a manner likely to cause serious **injury or damage** to the interests of the trade, industry or business to which it pertains; or
c. The financial position of the company is such as to endanger its **solvency**.
ii) Period Of Special Audit - Special audit shall be conducted for such period as may be specified in the **order of CG**.
iii) Appointment Of Special Auditor - Special auditor shall be appointed by CG.
The person appointed to conduct the special audit shall be –
a. Company's auditor; or
b. Any other **CA** (whether or **not** he is in **practice**).
iv) Powers And Duties - Special auditor shall have **same powers and duties** as that of a company's auditor.
v) Directions by CG - CG may direct any person to furnish to the special auditor such information as may be required by him.
vi) Report Of Special Auditor - The special auditor shall submit his **report to CG**. On receipt of report, CG may take such action, as it deems fit.
vii) Remuneration Of Special Auditor - Remuneration shall be **determined by CG.**

6.15 Cost Audit (Sec. 233B)

i) Cost Audit When Required - The company is compulsorily required to maintain cost records as per Sec.209 (1) (d); and **CG** has issued a **direction** to the company to conduct a cost audit.

ii) Qualifications Of Cost Auditor
a) Cost accountant; or **b) CA,** possessing the prescribed qualifications, if CG is of the opinion that - sufficient number of cost accountants are not available for conducting the cost audit; and a notification is issued to this effect
iii) Disqualifications Of A Cost Auditor
a. A person **disqualified** to act as a **statutory auditor** u/s 226.
b. The **statutory auditor** of the company.

iv) Vacation Of Office - The cost auditor shall vacate his office if after appointment; any of the **disqualifications** are attracted to him.

v) Appointment Of Cost Auditor
a. The cost auditor shall be appointed by the **Board**.
b. The appointment of cost auditor requires **previous approval of CG**.

vi) Ceiling On Number Of Audits
a. The auditor shall, before appointment, give a **certificate** of his eligibility to be appointed as cost auditor.
b. The certificate shall state that the appointment, if made, will be within the **ceiling on number of audits** as specified u/s 224 (IB).

vii) Powers And Duties Of Cost Auditor - The cost auditor shall have **same powers and duties** as that of a company's auditor.

viii) Cost Audit Report
a. The cost auditor shall submit a report to **CG and the company**.
b. The report shall be submitted within **180 days** of close of FY.
c. The Company shall furnish to CG **full information and explanations** on every reservation or qualification contained in cost audit report. The reply shall be submitted within **30 days** from the date of receipt of cost audit report.
d. CG may **call further information** from the company. The company shall furnish the information required by CG within the time specified by CG. CG may take such action as it deems fit.

ix) Duties of the Company
a. Give all **facilities and assistance** to the cost auditor.
b. Submit cost records to the cost auditor within **30 days** of the close of FY.

6.16 Gist Of Important Circulars
The gist of some important circulars issued by the Company Law Department is given below:

i) Statutory auditor cannot be internal auditor - This restriction is with a purpose to enable auditors to **express an independent and objective opinion** in their report under section 227.

ii) Retiring auditor cannot be deemed to be reappointed or automatically appointed at the annual general meeting - It is not correct to say that in absence of the resolution to the effect that the retiring auditors shall stand appointed as auditors of the company. Where auditors are **not** appointed or reappointed in accordance with the provisions of the Act, the appointment shall be made by the **government**.

iii) Continuation of tenure of auditors up to factual conclusion of next annual general meeting - Where **no** annual general meeting is held, the tenure of an auditor appointed under section 224 will continue up to factual conclusion of the **next annual general meeting** held by the company.

iv) The central government can exercise its powers to appoint auditors of a company only where **no auditors** have been **appointed** at the annual general meeting.

v) Interpretation of expression "other than retiring" as occurring in section 225(1) - Passing of a resolution at the annual general meeting appointing another person as an auditor of the company **without** mentioning the **words** in place of the **retiring auditor** is sufficient compliance with section 225(1)

vi) Consequence of non forwarding of notice to retiring auditor — Appointing a person other than the retiring auditor of the company at its annual general meeting as the auditor requires a **special notice** where **no** special notice has been sent to the retiring auditor, the resolution for appointing other persons as auditors or removing the existing auditors shall be **illegal and ineffective**.

vii) Where a Chartered Accountant is rendering services **professionally** and **not** as an **officer** of the company, he is not disqualified under section 226 (3) (b):

viii) Section 215 not contravened where audit of final account is completed before approval of balance sheet by the board of directors of the company — Section 215 (3) lays down that the balance sheet and profit and loss account of the company shall be **approved** by the **board of directors** before they are submitted to the **auditors** for their report there on. The company law board, however, does not consider that there is a contravention of section 215 in a case where the audit of final accounts is **completed** before such approval.

ix) Branch audit can be conducted at the head office without visiting branches - Where on the basis of his judgment of events and circumstances, the auditor decides **not** to **visit branches** for conducting his audit, he cannot be deemed to have discharged his duties improperly.

x) Appointment of a Chartered Accountant who is not in practice — The Central Government has powers to appoint a Chartered Accountant who is not in practice, to conduct the **special audit** of the company.

xi) Whether appointment of cost auditor as internal auditor, permissible - The cost auditor should **not** be appointed as the internal auditor for the **period** for which he is conducting the cost audit.

6.17 Dividends And Interim Dividends - A company desirous of declaring dividend on its shares will have to observe the following issues.

i) According to section 205(1), dividend can be declared or paid by a company for any financial year only out of:

a. Its profit for that year, arrived at **after** providing for **depreciation** as per Sec 205(2); or
b. Its profits for any **previous** financial year or years, after providing for depreciation as aforementioned and **remaining undistributed**; or
c. Out of **balances of profits** mentioned in (a) and (b) above; or
d. Out of moneys provided by the **Central or State Government** for payment of dividend pursuant to the guarantee given by the government.

ii) Transfer to Reserves - According to Section 205(2A), The Company shall transfer to its reserves, the prescribed percentage of its current year **reserves** profits (not exceeding 10%). Before declaration of dividend, profits shall be compulsorily transferred to reserves at the following rates:

Rate of proposed dividend on paid up capital	Minimum percentage of current year's profits to be transferred to reserves
Up to 10%	Nil
Exceeds 10% but up to 12.5%	2.5% of current year's profits
Exceeds 12.5% but up to 15%	5% of current year's profits
Exceeds 15% but up to 20%	7.5% of current year's profits
Exceeds 20%	10% of current year's profits

a. It is evident that no transfer to reserves is required if the rate of proposed dividend is 10% or less.
b. 'Rate of proposed dividend' mentioned above refers to -
• **equity dividend**, and
• part of dividend which participating **preference** shareholders are entitled to, after receiving their **fixed percentage** of dividend.
c. Requirement of transfer to reserves **equally** applies to declaration of **interim dividend**.
d. A company can voluntary transfer a **higher** percentage of its profits to the reserves in accordance with the Rules made by the **Central Government**.
e. 'current year's profits' means profits for current year **after** providing **depreciation**
f. 'reserves' **does not** include **capital reserve** or any reserve created by **revaluation**
g. In the event of inadequacy or absence of profits in any year a company can declare dividend out of its **past profits** which had been transferred to reserves, by complying with the Companies (Declaration of Dividend out of Reserves) Rules, 1975.

iii) Payment of Dividend - The followings rules have been framed regarding payment:
a. Dividends **once declared** become the liability of the company and should be paid within **30 days** of the date of declaration. Incase dividends have not been paid or claimed within 30 days, the company should within **7 days** from the expiry of 30 days, transfer such amounts to a separate bank account titled as **"Unpaid Dividend Account"**.
b. No dividend shall be paid except in **cash**.
c. Dividend should be paid to the **registered holder** of a share.
d. Though payment of dividend should be consented by company in a GM keeping in mind that amount **must not exceed** the amount recommended for distribution by the BOD.

iv) Provision for Proposed Dividend – Schedule VI to the Companies Act, 1956, requires proposed dividend to be shown under "Current Liabilities and Provisions". **AS-4** on Contingencies and Events Occurring After Balance Sheet Date also states that events which although take place after the Balance sheet date but reflect the financial position as on the such date should be included in the financial statements.

v) Provisions of the Income Tax Act, 1961 - The accounting and legal considerations are highly related. In determining the accounting profits, a number of provisions of the Income Tax Act have got to be considered, for example, the distributable profit of the company gets conditioned by the requirements to create and retain reserves in case of **shipping and hotel business**, etc.

vi) Setting off of brought forward debit balance of P&L A/c - Debit balance in the P&L A/c is a **part of Reserve & Surplus** as per revised Schedule - VI. In arriving at the divisible profits the provisions of Section 205 (2) (b) of the Companies Act, 1956, should be kept in view. Accordingly, the amount of loss or depreciation (contained in the debit balance of Profit and Loss Account) whichever is less, should be set off against current revenue profits before declaration of dividends.

Amendments relating to payments of Dividends —
As Per Section 2(14a), Dividend Has Been Defined To Include Interim Dividend Also.
Sub-section (IA) of section 205 provides that board of directors may declare interim dividend and the amount of dividend including interim dividend should be deposited in a separate bank account within **five days** from the declaration of such dividend.
Since interim dividend is also dividend, companies should provide for **depreciation** as required by section 205 and comply with the Companies (Transfer of Profits to **Reserves**) Rules, 1975 before declaration of interim dividend. The company has to provide estimated depreciation for the full year before declaring interim dividend.

6.18 Capital Profits - Capital profits represent the **excess** of sale value over original cost of assets like land, plant, investment, etc. The divisibility of such profits has been considered in an English case, viz., Foster V. The New Trinidad Lake Asphalte Co. Ltd. In this case the court decided that capital profits can be distributed by a company only if all the following conditions are fulfilled:
i) Articles of Association permit the distribution of Capital Profits.
ii) The capital profit which is sought to be distributed should be actually **realized**.
iii) The capital profit should remain after a **fair valuation** has been taken of the whole of the assets and liabilities.
However, **AS-10** on "Accounting for Fixed Assets" requires that any gain arising from disposal of assets should be recognized in the profit and loss account. Moreover, section 205 of the **Companies Act** does not make any distinction between capital and other profits. Thus all profits which can properly be taken to the profit and loss account are profits for the purpose of section 205 and are, thus distributable.

Revaluation Reserve: AS-10 on "Accounting for Fixed Assets", states that an **increase** in the net book value of the assets is normally credited to the owner's interest and under the heading Revaluation Reserve expect that, to the extent that such increase is related to and not greater than a decrease arising on revaluation previously recorded as a charge to the profit and loss account, it may be credited to the profit and loss account. A **decrease** in the net book value arising on revaluation of fixed assets should be charged directly to the profit and loss account expect that, to the extent such decrease is related to an increase which was previously recorded as, credit to revaluation reserve and which has not been subsequently reversed or utilized, it may be changed directly to Revaluation Reserve A/c.

i) Utilization of revaluation reserve for distribution of dividend: The **Guidance note** on Treatment of revaluation reserve states that where the value of fixed assets has been written up in the books of account of a company, the corresponding credit does not represent realized gain and is, therefore, **not** available for distribution as dividend.

ii) Utilization of revaluation reserve for adjusting accumulated losses: The Guidance note also states that accumulated losses and the depreciation on the acquisition cost (including arrears of depreciation) should **not** be **adjusted** against revaluation reserves since this would amount to setting off actual loss against unrealized gains.

iii) Utilization of revaluation reserve for issue of bonus shares: It has also been clearly provided that only such profits, as are earned by the company or capital receipts which are **realized in cash** (e.g. share premium),are available for issue of bonus shares. Thus shares cannot be issued out of revaluation reserves. if the management does not agree with this contention, the auditor should give a **qualified report**.

6.19 Auditor's Duty With Regard To Payment Of Dividend - The auditor should follow the following procedure for the verification of payment of dividends -
i) He should examine the **MOA & AOA** of the Company to determine the rights of different classes of shareholders to whom dividend has been paid.
ii) He should ensure that dividends can only be distributed out of **profits**.
iii) He should ascertain whether profits earmarked for the purpose of dividend have been computed in accordance with the requirements of **Section 205 of the Companies Act**.
iv) He should ascertain whether the **rate of dividend** has been recommended properly in a meeting of the BOD.
v) He should inspect the shareholders **minute book** to verify the amount of dividend declared & confirm that the amount does **not** exceed amount recommended by directors.
vi) He should see that profits appropriated for payment of dividend are after **transfer to reserves** an amount in accordance with the rules framed by the CG.
vii) He should examine the **list of shareholders** as drawn from the Registrar of Shareholders & see that total amount of dividend payable compares with Dividend Account.
viii) If a **separate bank account** is opened for payment of dividends, he should check the transfer of total amount of dividends payable from the Dividends Account.
ix) He should verify the amount of **unclaimed dividend** with the Dividend Account, bank Pass Book and dividend warrants as have been returned undelivered.
x) He should see that where the dividend is declared, distributed or paid by a domestic company (not a foreign company), the **tax** on distributed profit at the rate of **15%** is paid within **14 days** from the date of declaration, distribution or payment of dividend whichever is earliest. [Section 115(0) of the Income Tax Act, 1961]
xi) The auditor should see that the dividend which remains **unpaid or unclaimed** within 30 days of the declaration of the dividend, such unpaid or unclaimed dividend has been transferred to a **special bank account** entitled "Unpaid Dividend Account of Company Limited / Company Pvt. Limited". The transfer must be made within **7 days** from the date of expiry of 30 days. Such an account is to be opened only in a Scheduled Bank.
xii) If any dividend remains unpaid or unclaimed for a period of **seven years** from the date of transfer, the amount standing to the credit of the special bank account has to be transferred by the company to the fund called **Investor Education and Protection Fund**.

Right to Dividend, Right Shares and Bonus Shares to be Held in Abeyance Pending Registration of Transfer of Shares [Section 206 A] -
According To Section 206 A - Where any **instrument of transfer** of shares has been delivered to any Company for registration and the transfer of such shares has not been registered by the company, it shall, not withstanding anything contained in any other provision of this Act -
i) Transfer the dividend in relation to such shares to the **special account** referred to in Section 205A unless the company is authorized by the registered holder of such share **in writing** to pay such dividend to the transferee specified in such instrument of transfer; and
ii) Keep in abeyance in relation to such shares any offer of **right shares** under clause (a) of subsection (1) of Section 81 and any issue of fully paid-up **bonus shares** in pursuance of subsection (3) of Section 205.

6.20 Depreciation
i) Methods of Charging Depreciation - Section 205 of the Companies Act, 1956, prescribes the method of charging depreciation. As per the section 205, depreciation shall be provided either.
a. To the extent specified in section 350; or
b. In respect of each item of depreciable asset, on such amount as is arrived at by dividing **ninety five percent** of the original cost thereof to the company by the specified period in respect of such asset; or

c. On any other basis approved by the **CG** which has the effect of writing off by way of depreciation ninety five percent of the original cost to the company of each such depreciable asset on expiry of the specified period ; or
d. As regards any other depreciable asset for which no rate of depreciation has been laid down in this Act or rules made there under, on such basis as may be **approved** by the CG by orders published in the **Official Gazette**.
The **specified period** in respect of any depreciable asset shall mean the **number of years** at the **end** of which at least 95% of the original cost of the asset to the company will have been provided for by way of depreciation if depreciation were calculated in accordance with the provision of section 350.
As per schedule XIV, the company is required to **disclose** the **depreciation method(s)** used by the company. Part II of Schedule VI requires that if **no provision** is made for depreciation the **fact** should be stated and the **quantum of arrears** of depreciation computed in accordance with section 205(2) of the act shall be **disclosed** by way of a **note**.

ii) Adoption of different methods for different types of assets - A company may adopt more than one method for depreciation. Thus, it is permissible to follow **different methods** for different types of assets provided; the same method is consistently adopted from year to year.

iii) Change in method of providing depreciation - A company can shift from one method of charging depreciation to another only if the change.
a. Is required by the **statute**; or
b. Is required for compliance with an **accounting standard**; or
c. Would result in more appropriate **preparation or presentation** of the financial statements of the enterprise.
When a **change in the method** of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. Any **deficiency or surplus** in depreciation in respect of past years should be charged or credited to the profit and loss account. Such a change should be treated as a change in accounting policy and its effect should be quantified and **disclosed**.

iv) Rates of depreciation for the purpose of preparation of accounts of a company - Certain important aspects involved in an adoption of rates for depreciating assets are discussed below.
a. The rates as contained in schedule XIV are the **minimum rates**, and thus, no company can charge depreciation at rates lower than those specified in the schedule in relation to assets purchased. If, however, on the basis of bonafide technological evaluation, **higher rates** of depreciation are justified, they may be provided with proper disclosure by way of a **note to the final accounts**.
b. Where the concern has worked **extra shift**, extra shift allowance will have to be provided on plant and machinery, wherever applicable. In this regard various units / departments /factories should be taken as separate concerns. In cases where depreciation has not been provided in respect of extra/multiple shift allowance, it will his duty to **qualify his report**.

v) Pro-Rata Depreciation - Where during any financial year, any **addition** has been made to any asset, or where the asset has been **sold or discarded**, the depreciation on such assets will have to be calculated on a prorata basis. A company may group additions and disposals in appropriate time periods(s) for e.g. 15 days, a months, a quarter etc. for purpose of charging depreciation giving materiality of amounts involved due consideration. In the same manner, where accounts of the company are prepared for a period of **more than** 12 months, depreciation should be calculated on a **proportionate basis** for the period covered by the financial statements.

vi) Depreciation on low value items - The concept of **materiality** should be borne in mind while writing off low value items. The materiality level for a small company will be lower than the materiality level of a large company. It is recommended that the accounting policy followed by the company in this regard should be **disclosed** appropriately in the accounts.

vii) Computation of managerial remuneration - For the purposes of calculating managerial remuneration **depreciation** should be provided as per section 350.

viii) Charging depreciation in case of revaluation of assets - According to the part II of schedule VI to the Companies Act, the company will have to provide for depreciation on the **total book value** of the fixed assets (including the increased amount as per revaluation) in the profit and Loss Account for the period and thereafter the company can transfer an amount equivalent to the **additional depreciation** from the Revaluation Reserve. Such transfer should be shown separately. However, for purposes of dividends, managerial remuneration, etc. only depreciation relatable to the **historical cost** of the fixed assets has to be provided. The **revaluation** of fixed assets is done in order to bring into books the **cost** of the asset. Thus, it will be prudent not to charge additional depreciation against revaluation reserve. This will enable the company to build up reserves for replacement of the fixed assets.

6.21 Concept Of True And Fair

i) The concept of true and fair is fundamental concept in auditing. The phrase "true and fair" In the auditor's report signifies, that the auditor is required to express his opinion as to whether the **state of affairs and the results** of the entity as ascertained by him in the course of his audit are **truly and fairly represented** In the accounts under audit.

ii) What constitute true and fair, however, has **not been defined in any legislation.** In the context of audit of a company, however, Section 211(5) of the Act provides that the accounts of a company shall be deemed as not disclosing a true and fair view, if they do **not disclose any matters** which are required to be disclosed by virtue of provisions of **Schedule VI** to that Act, by virtue of a notification or an order of the CG modifying the disclosure requirements.

iii) In case of companies, which are governed by **special Acts**, it should be seen whether the disclosure requirements of the governing Act are complied with. It must be noted that the disclosure requirements laid down by the law are the minimum requirements.

iv) If certain **information is vital** for showing a true & fair view, accounts should disclose it even though there may not be a specific legal provision to do so. Thus what constitutes a 'true and fair' view is a matter dependent on particular circumstances of a case.

CASE STUDIES

Q1. Y Ltd. purchased an existing bottling unit. The method of charging depreciation on machinery of the acquired unit was different from that followed by the company in its other units. The company wants to continue to charge depreciation for the acquired unit, in the method followed earlier by them and which was too consistent with their own method.
Ans: Guidance Note on Accounting for Depreciation in companies issued by the Institute recommends that a company may adopt more than one method of depreciation. Therefore, it is permissible to adopt or follow **different methods** of depreciation, **for different types of assets,** provided the same methods are **consistently** adopted every year in terms of section 205(2) of the Companies Act, 1956. Also units in **different geographical**

locations can follow different methods of depreciation on machinery provided the same are consistently followed.

Q2. In the previous year "Y" Ltd. has made a provision of 10% of the contract value on an ongoing project. The actual loss on completion of the contract in the subsequent year was 11%. The management adjusted the difference in the previous year's account.
Ans: AS-5 on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, states that the **effect of a change** in an accounting estimate should be included in determination of net profit or loss in the period of the change, if the change affects the period only. Thus, the management should adjust the difference in the current period only. Alternatively, the auditor should qualify his report.

Q3. Shyam Ltd. has a paid up capital of Rs. 40 crores divided into equity shares of Rs. 10 each as on 31.03.2008. During the financial year 2008-09 it has issued bonus shares in the ratio 1: 1. The net profit after tax for the years 31-03.2008 and 31.3.2009 is Rs. 20 crores and Rs. 30 crores respectively. The Earnings Per Share (EPS) disclosed in the FS for the above two years is Rs. 5.00 and Rs. 3.75 respectively. Is the disclosure correct?
Ans: As per **AS 20** on Earning Per Share, in the case of a bonus issue, the number of equity shares outstanding before the event of a bonus issue to be adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. Since the above figures of EPS have not been disclosed, Shyam Ltd. has not complied with the provisions of AS 20. Therefore, the auditor would have to qualify his report in terms of section 227(3)(d) of the Companies Act, 1956.

Q4. The company has sold some old machinery for Rs. one crore. The details of the cost of such machinery are not available since the entire records relating to fixed assets have been destroyed in an earthquake.
Ans: AS 10 on "Accounting for Fixed Assets", gains or losses arising on disposal are generally recognised in the profit and loss statement. An all out attempt should be made by the management to **reconstruct the old records** by obtaining old copies of annual reports filed with ROC AND IT and determine the WDV of the asset. The auditor will have to see whether the estimate of cost and WDV arrived at in the above manner by the company is **reasonable** and whether the profit/loss is determined accordingly. A **note** to that effect would also have to be given **by the management** in the **accounts**. If the auditor is of the opinion that the said estimates are satisfactory based on available records and the note given by management explains the said fact, he may not qualify his report. If he is not so satisfied, he would have to give disclaimer in the audit report that in the absence of proper records, the said profit/loss has been arrived on an estimated basis and in that view he has been unable to form an opinion. As far as the report under the **CARO, 2003 order** is concerned; the auditor would have to point out that proper records of fixed assets showing full particulars as required by that clause are not available.

Q5. The company had subscribed to shares of associate companies amounting to Rs. 5 crores. These associate companies have incurred substantial losses and have been referred to BIFR for being declared as sick companies. The company does not want to make any provision for the fall in the value of the investments.
Ans: AS 13 states, "long-term investments should be carried in the FS at cost. However, provision for diminution shall be made to recognise a decline, **other than temporary**, in the value of the investments, such reduction being determined and made for each investment individually". In the instant case, these associate companies have incurred substantial losses and have been referred to BIFR for being declared as sick companies. Therefore, such fall cannot be merely temporary as the companies could take a long time to turn around (if at all) and again have a positive net worth. The auditor would therefore have

to **qualify his report** by saying that no provision for diminution for fall in the value of investments as required by AS 13 has been made and to that extent the profits and reserves have been overstated.

Q6. As at the beginning of the year, the company has a capital of Rs. 5 crores, free reserves of Rs. 1 crore and Revaluation Reserve of Rs. 9 crores. In the relevant year under audit the company has incurred a loss of Rs. 8 crores. The company proposes to adjust the loss with the Revaluation Reserve.
Ans: AS 10 on "Accounting for Fixed Assets" states that an increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. The **Guidance Note** on Treatment of Reserve created on Revaluation of Fixed Assets states that where the value of fixed assets is written up in the books of account of a company, the corresponding credit appearing as revaluation reserve does not represent a realised gain and is, therefore, not available for distribution as dividend. Similarly, accumulated losses and the depreciation on the acquisition cost (including arrears of depreciation) should **not be adjusted** against revaluation reserve since this would amount to setting off actual losses against unrealised gains. The auditor should **explain to the management** that accumulated losses cannot be adjusted against the revaluation reserve created on revaluation of the fixed assets. If the management does not agree with the opinion of the auditor, the auditor may even issue an **adverse report**.

Q7. What do you understand about Reserved Capital as provided under Section 99 of the Companies Act, 1956? How is it different from Capital Reserve? (NOV 2009 NEW)
Hint Ans: As per Section 99 of the **Companies Act,** 1956, a limited company may, by a Special Resolution determine a portion of its share capital not being called-up, is to be kept reserved and shall be called-up, in the event and for the purpose of being wound up. Certain capital profit is transferred to Capital Reserve, which is not a free-reserve. It is not available to distribute as dividend to shareholders. It is generally utilized to write-off capital losses. For example, Profit on re-issue of forfeited shares.

Q8. Section 274 of the Companies Act, 1956 is applicable to appointment of Directors. Briefly explain your duty as a statutory auditor in this connection.
Hint Ans: As per section **274(1)(g)** of the Companies Act, a director is qualified if:
- The concerned public company has not filed the annual returns/accounts for any 3 continuous financial years on or after 1-4-1999.
- The director in such a case becomes disqualified on last date for filling above documents.
Section **227(3)(f)** of the Companies Act, 1956 requires the statutory auditor to state whether any director is disqualified from being appointed as director u/s 274(1)(g). Ministry of Company Affairs has also issued the Companies (Disqualification of Directors under section 274(1)(g) of the Companies Act, 1956) Rules, 2003. **Rule 4** requires that the statutory auditors of both the appointing as well as the disqualifying company to:
a. report under section 227(3) of the Act to the members of the respective companies as to whether any director is disqualified from being appointed as a director under clause (g) of section 274(1) of the Companies Act, 1956; and
b. furnish a certificate every year as to whether on the basis of his examination of the books and records of the company, any director of the company is disqualified as a director or not.
The auditor is required to obtain written representation as to names of directors, particulars of appointment, default by the company, etc. As a part of audit procedures, the auditor is required to obtain the necessary information before giving his report. The auditor is required to obtain evidence in the form of written representation from a director in respect of each such company has not defaulted in terms of the section 274(1)(g). The written representation should also be noted and taken on record by the Board. The auditor should

also verify the information provided by the management and direction from the information contained in the register mentioned u/s 303(1) of the Act. Accordingly, the auditor is required to report appropriately.

Q9. In the books of accounts of M/s Opaque Ltd. huge differences are noticed between the control accounts and subsidiary records. The Chief Accountant informs that this is common due to huge volume of business done by the company during the year.
Ans: The huge differences found between control accounts and subsidiary records in the books of M/s Opaque Ltd. indicate that there may be **material misstatements** requiring detailed examination by the auditor to ascertain the cause. Further, when the auditor encounters circumstances that there is material misstatement, the auditor should perform procedures to determine whether the FS are materially misstated. If as a result of such examination the auditor comes across any material information involving **fraud or gross irregularity** the same shall be reported by him appropriately.

Q10. The liability of audit fees of a company has been outstanding since last two years. After having completed the audit for the current financial year, the auditor asked the company to pay his audit fees for all the three years so that audit report of the current year may be handed over to the company. In view of the above, discuss the rights of the auditor to receive the remuneration.
Ans: Section 224(8) of the **Companies Act, 1956** deals with fixation of remuneration of an auditor. However, the Act is silent on the mode of recovery of remuneration by an auditor. Normally speaking, an auditor has right to receive his remuneration after completing his work, that is, submission of the audit report. As per **Expert Advisory Committee** of the Institute, the auditor may also recover his fees on **progressive basis.** But as a matter of professional ethics it would not be proper on part of auditor if he links delivery of the audit report conditional upon receipt of audit fees. As such it would be better on the part of the auditor to enforce his right to receive remuneration through **court of Law** only after submitting his report.

Q11. Special audit can be ordered by the CG under section 233A of the Companies Act, 1956 if a company sustained losses for two years and the Special Auditor may not be a CA in practice.
Ans: Special Audit under section 233A of the Companies Act, 1956 can be ordered by the CG, if it is of the opinion –
(i) That the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices; or
(ii) that any company is being managed in a manner likely to cause serious injury or damage to the interests of trade, industry or business to which it pertains; or
(iii) that the financial position of any company is such as to endanger its solvency.

In view of the aforesaid, mere incurrence of losses continuously for two years **may not be a valid ground** for ordering special audit unless the solvency of the company is endangered. Therefore, this proposition is false. However this section empowers the CG to appoint a **CA (whether or not such CA is in practice) or the company's auditor** himself to conduct the special audit.

Q12. Mr. X, a shareholder of the company pointed out that:
(i) The goodwill in B/S of the co. has appeared on same figure during the past three years.
(ii) Premium received on issue of shares prior to the date of balance sheet has been transferred to P&L account for arriving at the figure of commission payable to the MD.
Ans: (i) As per the provisions of **AS 26 "Intangible Assets",** an intangible asset should be carried in the books at cost less accumulated amortization and accumulated impairment

losses. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a reputable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. In the given case, the company has not amortized any value of goodwill since past three years. The auditor should have indicated this fact in his report that no amount of goodwill has been written off during the past three years.

(ii) Premium received on issue of shares is capital receipt and should not be credited to profit and loss account. As per the provisions of Section 349 of the **Companies Act**, 1956, premium on issue of shares should not be considered in computation of net profit for the purpose of managerial remuneration. The auditor should have qualified the audit report and qualified the amount by which the profit stands inflated.

Q13. The BOD of a company has filed a complaint with the ICAI against their statutory auditors for their failing to attend the AGM of the Shareholders in which audited accounts was considered.
Ans: Section 231 of the **Companies Act**, 1956 confers right on the auditor to attend the GM. The said section provides that all notices and other communications relating to any GM of a company which any member of the company is entitled to have are also to be forwarded to the auditor. Further, it has been provided that the auditor shall be entitled to attend any GM and to be heard at any GM which he attends on any part of the business which concerns him as an auditor. Therefore, the section does not cast any duty on the auditor to attend the annual GM. The law only confers right on the auditor to receive notices and also attend the meeting if he so desires. Therefore, the complaint filed by the BOD is based on mis-conception of the law.

Q14. A company has a post tax profit of Rs. 15, 00,000 for 2001 -02. The company transferred Rs. 200,000 to development reserve. The company has proposed a rate of dividend @ 12% on its equity capital of Rs. 800,000 and @ 10% on its 10% Cumulative Participating Preference Share capital of Rs. 600,000. The company proposed to transfer 3% of the current profits to the reserves.
What will be your opinion in case the company proposed to pay additional dividend @ 2% to its preference share holders?
Hint Ans: In the first case, the contention of the management are within the provisions regarding transfer of profits to reserves because the rate of equity dividend being 12% the Company is require to transfer just 2.5% of its current profits to the reserves and the management proposes to transfer 3% to reserves.
However, in the second case, the additional 2% dividend paid to preference share holders will be within the ambit of the said rules only when the company proposes to transfer at least 5% of the profits to the reserves, because the rate of dividend proposed by the Company goes up to 14%.

Q15. S.T. Limit appointed at the AGM, E as auditor and F as the joint auditor. The resolution provided that in the event of both or either declining the appointment, the Board may fill up the vacancy at their discretion. The BOD resolved that In the event of either E or F declining to accept the appointment, G be appointed as joint auditor. F declined the appointment and G was asked to intimate his willingness or otherwise to accept the appointment. Advise G with reasons whether his appointment is valid.
Hint Ans: It may be noted that under the Companies Act, the BOD could appoint an auditor only under the circumstances contemplated under sub-section (5) and under the sub-section (6a) of Section 224. Further in this specific case, the refusal of F to accept the appointment as joint auditor did not create a vacancy either casual or by resignation since

F's appointment has not been become effective. Therefore, appointment of G by the Board would not be valid.

Q16. Comment on the following: A company has a branch office which recorded a turnover of Rs. 1, 90,000 in the financial year 2004-05. No audit of the branch has been carried out. The statutory auditor of the company has made no reference of the above branch in his report. The total turnover of the company is Rs.10 crores for the year 2004-05.
Hint Ans: Refer Point No. 6.13

Q17. You have been appointed the sole statutory auditor of a company where you were one of the joint auditors in the immediately preceding year. The concerned joint auditor has not been reappointed. What are the various steps you would take to ascertain the compliance of the requirements of the Companies Act, 1956 before accepting the audit?
Hint Ans: When one of the joint auditors of the previous year is appointed as the sole auditor for the next year, it is similar to re-appointment of one of the retiring joint auditors. The provisions of section 225 of the Companies Act, 1956, relating to non-reappointment of the other person also need to be considered. (**Refer** Point No. 6.3-iii and 6.7-iii)

Q18. The rate of equity dividend declared and paid by the company are as follows:

2003-04	15%
2004-05	12%
2005-06	12%

The Company has earned sufficient profit after tax in 2006-01 and wishes to proposed dividend on equity shares @ 11% and proposes to transfer 12% of profits to reserves. No bonus shares have been issued during the last few years. The post tax profit in 2006-07 is higher than the corresponding profit of each of the previous three years.
Will it make any difference if the company proposed a 20% rate of dividend?
Hint Ans: In the instant case, the company proposes to transfer to reserves, more than 10% of the profits for the current year. As per **Companies (Transfer of Profits of Reserve) Rules, 1975**, such company shall have to at least maintain the average rate of dividend in the immediately three preceding years, which works out to 13% of dividend.
If the company pays a dividend @ 20%, the actions will be well within the ambit of the said rules as it paying higher than the average rates of dividend.

Q19. In the above Illustration, if the profit for 2006-07 is less by 20% of average profits of 2004-05 and 2005-06, can it transfer 12% of profits to reserves and pay dividend @ 11%.
Hint Ans: As per the rules, incase profits for current year are lower than 20% compared to average net profit after tax in the immediately two preceding years, the company is not required to maintain average rate /amount of dividend during the preceding three years.

Q20. As an auditor, how would you deal with the following?
A Ltd. has not made provisions for proposed dividends in its accounts but proposes to charge the dividends to Profit and Loss account as and when paid. (June 2009)
Hint Ans: The council recommends that non-provision for proposed dividends should be disclosed by means of a note in the accounts and that the auditor should refer to the note in his report and makes his report subject thereto.

Q21. As an auditor, how would you deal with the following? During the audit for the year ended on 31st March, 2009 of XYZ Ltd. you come across certain personal expenses of employees having been debited to P&L account. (June 2009)
Hint Ans: The charging of such personal expenses of the employees by the company to its profit and loss account is justifiable or not depends upon the terms and conditions of

appointment of the employees. If the terms and conditions of employment include payment of expenses of personal nature, then such expenses can be incurred by the company.

QUESTIONS

Q1. X Ltd., paid Rs. 25 lakhs as advance to Y Ltd. towards the purchase of printing machinery on 15.1.08 with delivery instructions to deliver the same in the last week of June, 08. Further on 2.2.08 X Ltd. purchased two diesel generator sets from Y Ltd. for Rs. 30 lakhs on 90 days Credit term. In the accounts for 2007-08, X Ltd. intends to adjust the advance paid against Credit purchase and show the net amount of Rs. 5 lakhs as due from them. As the statutory auditor, how would you deal with this? (5 Marks) **(Nov 2008)**

Q2. As Auditor of Act Fast Ltd. what steps will you take to ensure that the dividend has been paid only out of profit? (8 Marks) **(Nov 2008)**

Q3. What are the duties of a statutory auditor regarding disqualification of a director u/s 274(1) (g) Of the Companies Act, 1956? (8 Marks) **(June 2009)**

Q4. What do you understand about Reserved Capital as provided under Section 99 of the Companies Act, 1956? How is it different from Capital Reserve? (4 Marks) **(Nov 2009)**

Q5. (a) Mr. Ram, a relative of a Director was appointed as an auditor of the company. Comment (6 Marks) **(Nov 2010)**
(b) Mr. X, Director of ABC Ltd. made a purchase contract for Rs. 10, 00,000 with the company. Comment (5 Marks) **(Nov 2010)**

Q6. During audit, X, the Auditor of ABC Ltd. observes that certain loans & Advances were made without proper securities, certain debtors and creditors were adjusted Inter se and personal expenses were charged to revenue. Comment (6 Marks) **(Nov 2010)**

Q7. Z Ltd. has flexi deposit linked current account with various banks. Cheques are issued from the current account and as per the requirements of funds, the flexi deposits are encased and Transferred to current accounts. As of 31st March, 2011 certain cheques issued to vendors are not presented for payment resulting in the credit balance in the books of the company. The management wants to present the book overdraft under current liabilities and flexi deposits under cash & bank balances. Comment (8 Marks) **(May 2011)**

Q8. X Ltd. did not follow the applicable Accounting Standard for disclosing Earnings per Share (EPS) in the FS. The fact of such non-disclosure was however, mentioned in the notes forming part of accounts. As the statutory auditor of X Ltd., how would you report in the above case? (5 Marks) **(June 2009)**

Q9. XYZ Limited received a grant of Rs. 25 lakhs under the Government's Subsidy Scheme, for acquiring imported machinery for setting up new plant. The entire grant received is credited to Profit and Loss Account. (5 Marks) **(Nov 2009)**

Q10. In the course of audit of T Ltd. you observed that export incentives are not accounted on accrual basis. The company's management contended that these would be accounted on cash basis citing the uncertainty about its receipts as they are not admitted as due by the customs authorities. Comment (4 Marks) **(May 2011)**

7. LIABILITIES OF AUDITORS

7.1 Nature of Auditor's Liability -
i) An auditor is appointed under a statute or under an agreement to carry out some professional work it is to be presumed that he shall carry them out completely and with the **care and diligence expected** of a member of the profession.
ii) The auditor is expected to discharge his duties according to "**generally accepted auditing standards**" obtaining at the time when the professional work is carried out.
iii) Either absence of the requisite skill or failure to exercise reasonable skill can give rise to an action for **damage** for professional negligence.
iv) Taking assistance in the discharge of his duties - The work of an auditor being of a personal character, it must be performed either by him or by his persons under his supervision since he himself remains **finally responsible**.

7.2 Professional Negligence - It consists of the following three elements:
i) Existence of Duty or Responsibility –
a. If the **client incurs loss** through the action of the auditor, his liability will be determined on the basis of the terms of engagement.
b. When a **third party incurs loss** it is necessary to find out whether the auditor owed any duty to him.
ii) Breach Of Duty Or Negligence –
a. To charge a professional with breach of duty or negligence, it is necessary to **prove deviation** from established performance procedures and standards.
b. Though the auditor does not guarantee success of his efforts, he should nevertheless exercise **reasonable skill and judgment** while discharging his duties.
iii) Led To Losses - The established rule of law is that there will be no damages without losses. Thus the auditor will be liable to **reimburse losses** to the extent caused due to his negligence.

7.3 Civil Liabilities Under Companies Act, 1956
The civil action against the auditor may take the form of claim for damages on account of negligence in performance of duties or misfeasance proceedings.
i) Damages for Negligence - Action for damages can be brought against auditor for:
a. Untrue statement given by him as an expert in the prospectus. The auditor will be able to avoid this liability if he:
Withdrew his consent before delivery of the prospectus to the registrar; or
• After the **registration** of prospectus but before any allotment was made there under, has withdrawn his consent to it and given public notice of the withdrawal of consent; or
• was competent to make such statement and had reasonable **ground to believe** that his statements were true.
b. Liability for damages may also arise in cases where a **loss is suffered** by the company or third party **due to professional negligence** on the part of the auditor.
ii) Liability for Misfeasance - The term misfeasance implies breach of trust or duty. The auditor of a company can be held liable for misfeasance if he has been guilty of any breach of duties or negligence in performance of duties, which has **resulted in some loss** or damage to the company.

7.4 Criminal Liability Under Companies Act, 1956 - In the following cases criminal proceedings can be instituted against the auditors:
i) In case the auditor **authorized the issuance** of a prospectus containing an untrue statement. If, however, the auditor acting only as an **expert** gave an untrue statement, **only civil proceedings** can be instituted.
ii) He can be held criminally liable if, with the **intent to defraud** or deceive any person, he

a. destroys, mutilates alters, falsifies etc. any books, papers or securities of the company;
b. makes or is privy to the making of any **false or fraudulent entries** in any register or books of accounts or documents belonging to the company.
iii) In case he, as a past or present auditor, has been held **guilty of an offence** in relation to the company.
iv) In case the auditor in any return, certificate, prospectus or other documents required by or for the purpose of the act, makes a statement which:
a. is false in any material particular, **knowing it to be false**; or
b. omits any material fact, knowing it to be material.

7.5 Liabilities Under Income Tax Act, 1961

A CA acts as an authorized representative of his clients and attends before the Income Tax Authorities or the Appellate Tribunal. His liabilities as a representative under the Income Tax Act are given below –
i) Under Section 288: In the following cases a CA is prohibited from representing his clients before the Income Tax Authorities:
a. he has been convicted of any **offence** under the Income Tax Law; or
b. he has been found **guilty of professional misconduct** by the ICAI.
ii) Under Section 278: Where a CA **makes or induces any persons** to deliver false documents, accounts or statements to the Income Tax Authorities, relating to income chargeable to tax which he knows to be false or does not believe to be true.
iii) Under Rule 12A: Under this rule a CA who as an authorized representative has prepared the return filed by the assessee, has to furnish to the Assessing Officer the particulars of accounts, statements and other documents supplied to him by the assessee for the preparation of the return. Where a CA has conducted **an examination** of such records, he has also to submit a report on the scope and results of such examination. If the **report contains any false information**, which the CA knows or believes to be false, he would be liable for imprisonment and a fine.

7.6 Auditor's Liability For Negligence In Relation To Prospectus

i) Auditor's Report In A Prospectus:
a. A CA's Certificate or Report may be used in the Prospectus in connection with financial forecasts. Hence, he is connected with the issue of Prospectus in his capacity as an **Expert**.
b. The term "Expert" u/s 58(2) includes, among others, an accountant and "**any other person whose profession** gives authority to a statement made by him".
ii) Liability For Untrue Statement: (May 2010)
a. The Directors of a Company and persons connected with the issue of the Prospectus **as Expert** (whose reports form part of the Prospectus) are liable to pay compensation to aggrieved persons for any misstatement / untrue statement in the Prospectus. [Sec.62]
b. If the misstatement could be attributed to the **Auditor's Report** in the prospectus, he would be liable to compensation to the persons who have financially suffered due to their having acted on the basis of the Auditor's Report in the prospectus.
c. The measure of damages u/s 62 is the **loss suffered** by reason of the untrue statement.
d. A statement may be considered to be untrue, not only because it is so but also if it is **misleading in the form and context** in which it is included. [Sec.55]
iii) Exceptions:
The Auditor can avoid this liability if he is able to prove -
a. That after he had given his consent u/s 58 in writing, the same was **withdrawn before** any copy of the Prospectus was **delivered for registration**, or
b. That after registration of the Prospectus but **before any allotment** was made there under, he, on realizing that the statement was untrue, had withdrawn his consent in writing and had given reasonable public notice of the withdrawal and reasons thereof, or

c. That he was competent to make the statement and that on **reasonable grounds** he believed and has **continued to believe up to the time of allotment** of Shares of Debentures, that the statement was true.
iv) Penalty for False Statements - Also u/s 628, an Auditor can be held liable for criminal prosecution, if in any return, certificate, Balance Sheet, Prospectus, Statement or other document required by or for the purpose of the Act, he makes a statement:
a. which is **false** in any material particular knowing it to be false, or
b. which **omits any material fact** knowing it to be material. If convicted, he can be punished with imprisonment up to 2 years and also with me.

CASE STUDIES

Q1. Indicate the precise nature of auditor's liability in the following situation and support your views with authority, if any: Certain weaknesses in the IC procedure in the payment of wages in a large construction company were noticed by the statutory auditor who in turn brought the same to the knowledge of the MD of the company. In the subsequent year huge defalcation came to the notice of the management. The origin of the same was traced to the earlier year. The management wants to sue the auditor for negligence and also plans to file a complaint with the Institute.
Ans: **Refer** SA 265 Point No. C; The fact that the matter was brought to the notice of the managing director may be a good defence for the auditor as well. According to the judgement of the classic case In re Kingston Cotton Mills Ltd., (1896) it is the duty of the auditor to probe into the depth only when his suspicion is aroused.

Q2. Based upon the legal opinion of a leading advocate, Amrit Ltd. made a provision of Rs. 5 crores towards Income Tax liability. The assessing authority has worked out the liability at Rs. 5 crores. It is observed that the opinion of the advocate was inconsistent with legal position with regard to certain revenue items.
Ans: SA 620, "Using the Work of an Expert" states that the auditor has to evaluate the work of an expert, say, actuary, before adopting the same. There is no doubt that appropriateness, reasonableness of assumptions and methods used are the responsibility of the expert, but the auditor has to determine whether they are **reasonable** based on the auditor's knowledge of the client's business and result of his audit procedures. In fact, **SA 620** makes it incumbent upon the part of the auditor to resolve the inconsistency by discussion with the management and the expert .In case, the expert's' work does not support the related representation in the financial information the inconsistency in legal opinions could have been detected by the auditor if he had gone through the same. This seems apparent having regard to wide difference in the liability worked out by the assessing authority. Under the circumstance, the auditor should have rejected the opinion and insisted upon making proper provision.

Q3. Explain the liability of the auditor under section 62 of the Companies Act, 1956, for making an untrue statement in the report (as an expert forming a part of the prospectus).
Ans: Refer Point No. 7.6 (ii)

QUESTIONS

Q1. Explain the liability of the auditor u/s 62 of the Companies Act, 1956, for making an untrue statement in the report (as an expert forming a part of the prospectus). (5 Marks) **(May 2010)**

8. AUDIT REPORT

8.1 Types Of Audit Report (Audit Opinion) – There are two types of Opinion:
i) Unqualified Opinion – SA 700, "Forming an Opinion and Reporting on Financial Statements" states that the auditor shall express an **unmodified opinion** when the auditor concludes that the FS are prepared, in all material respects, in accordance with the applicable financial reporting framework.
The auditor issues a clear report in case he does not have any reservations in respect of matters contained in the financial statements. In such a case, the audit report may state that the FS give a true and fair view of the state of affairs and profit and loss account during the period. For issuance of unqualified report, the auditor should satisfy himself that -
a. Reasonable evidence is obtained in support of the transactions recorded in the books of account;
b. Accounting entries passed in the books of account are in conformity with the applicable accounting principles and standards followed consistently;
c. The financial statements prepared represent a true summary of transactions that took place during the year;
d. The process of classification and aggregation followed in preparation of the financial statements is fair and does not hide a material fact nor does it highlight something which may distort the real state of affairs. The form of accounting statement is in the required form, if any;
e. The accounting statements do not contain any misstatement;
f. The material transactions recorded in the books are neither illegal nor beyond the legal powers of the client; and
g. All statutory and relevant disclosures have been made.

Circumstances That May Result In Other Than Unqualified Opinion
a. Limitation of Scope - The client or circumstances may impose the limitation of scope on auditor's work.
b. Disagreement with Management - The disagreement may be as regards the applicability of accounting policies or the method of their application including the adequacy of disclosures in the financial statements.
c. Uncertainty - A significant uncertainty, the result of which will be dependent upon resolution of future events may cause the auditor to qualify his report. For example, a litigation involving legal claims against the company.

ii) Modified Opinion – Form of Opinion - SA 700, "Forming an Opinion and Reporting on Financial Statements" states that if the auditor:
a. Concludes that, based on the audit evidence obtained, the FS as a whole are **not free** from material misstatement; or
b. is **unable to obtain sufficient appropriate audit evidence** to conclude that the FS as a whole are free from material misstatement; the auditor shall **modify the opinion** in the auditor's report in accordance with SA 705.

Refer "SA 705 - Modifications to the Opinion in the Independent Auditor's Report" in Chapter 1 "Standards on Auditing" for types of Modified Opinion.

8.2 Signature On Audit Report (Section 229)
i) Only a person **appointed as an auditor** of the **company** can sign the Auditor's Report or sign or authenticate any other document of the company that is required to be signed by the auditor as required under the Act.
ii) Where a firm is appointed as the auditor of the company under Section 226 of the Companies Act, 1956, only **a partner** of **that firm** can sign such a report.

iii) Branch auditor should sign **report** of audit of **branch** of Co. in the same manner.

8.3 Audit Reports Under Companies Act, 1956 - The auditor's reporting requirements are contained in sub-section (1A), (2), (3), (4) & (4A) to sec. 227. The matters, which auditor has to report, could be classified into **two** categories: **Statement of facts & Opinions**

A. Statement Of Facts - Report On Specific Enquiries Under Section 227 (1A): He is **not required to report** on these matters **unless** he has any **special comments** to make
a. Sec. 227 (1A) requires the auditor to make specific enquiries during **conduct** of **audit**.
b. The auditor is **not** required to **report** on these matters unless he has any **special comments** to make.
c. It should be understood that the auditor should only **enquire** on the specified matters and is **not** to **investigate** into them. The matters required to be enquired into are -
• Whether **loans and advances** made by the company on the basis of security have been **properly secured &** terms on which they have been made are not prejudicial to interests.
• Whether transactions of the company, which are represented merely by **book entries**, are not prejudicial to the interests of the company.
• Whether the company is not an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been **sold at a price less** than that at which they were **purchased** by the company.
• Whether loans and advances made by the company have been shown as **deposits**.
• Whether **personal expenses** have been charged to revenue account.
• Where it is stated in the books and papers of the company that any shares have been **allotted for cash**, whether cash has **actually** been so **received** in respect of such allotment, and if no cash has actually been so received, whether the position as stated in account books and balance sheet is correct, regular and not misleading.

B. Statement Of Opinion –
a. Report Under Section 227(2) - The auditor has to state whether, in his **opinion** the said accounts give the information required by this act in the specified manner and give a **true and fair view** -
• in the case of the **B/S**, of the state of company's affairs as at the end of its financial year;
• in the case of the **P&L account**, of the profit or loss for its financial year.
b. Report Under Section 227(3) - The auditor's report should state -
• Whether he has obtained all the **information and explanations;**
• Whether in his opinion, proper **books of account** have been kept;
• Whether any **director** is **disqualified** from being appointed as a director.
• Whether the **B/S and P&L A/c** are in **agreement** with the books of account & returns;
• Whether **Accounting Standards** have been complied with;
• Whether the report of **branch auditor** has been forwarded to him and how he has dealt with the same in preparing his audit report;
• The observations or comments of the auditors which have any adverse effect on the functioning of the company in **thick** type or in italics;
• Whether cess or **tax payable** by the company has been so paid.

C. CARO - Companies (Auditor's Report) Order, 2003
i) Short Title, Application and Commencement
a. This order may be called the **Companies (Auditor's Report) Order, 2003**.
b. It shall **apply** to **every company** including a **foreign company**, except the following:
• a **Banking company** as defined in clause (c) of sec. 5 of Banking Regulation Act, 1949;
• an **insurance company** as defined in clause (21) of section 2 of the Act;
• a company licensed to operate under **section 25** of the Act; and

• a **private limited company** with a **paid up capital and reserves** not more than **fifty lakh** rupees and does not have **loan** outstanding exceeding Rupees **Twenty Five Lakhs** from any bank or financial institution and does not have a **turnover** exceeding **five crore** rupees at any point of time during the financial year.

ii) Important Points:
a. Paid-up share capital includes both Equity share capital & the Preference share capital.
b. Both capital as well as revenue reserves should be taken into consideration
c. Revaluation reserve, if any, should also be taken into consideration.
d. The debit balance of the P&L A/c should be reduced from the figure of revenue reserves.
e. Outstanding balances of such loans should be considered as loan outstanding for the purpose of computing the limit of rupees twenty five Lakhs.
f. Turnover:
• **Inclusion -** Commission allowed to third parties
• **Exclusion – ~** Sales tax collected or excise duties collected if they are credited separately to sales tax account or excise duty account. **~** Trade discounts **~** Sales returns even if of earlier years.

iii) 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:
1. Fixed Assets
a) The company has to give the following particulars regarding the fixed assets:
• Description of the fixed assets • Identification No • Original Cost • Depreciation rate
• Adjustment for Revaluation
b) Whether the company is maintaining proper **records** showing full particulars, including **quantitative details** and **location** of fixed assets;
c) 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;
d) if a substantial part of fixed assets have been **disposed off** during the year, whether it has **affected** the **going concern**;

2. Inventories
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;

3. Loan to/from Directors and Interested Parties
a) Has the company **granted** any loans, secured or unsecured to Cos. firms or other parties covered in the register maintained U/s 301 of the Act. If so, give the following details:
i) Name of the Party **ii)** Relationship with Co. **iii)** Amount **iv)** Year-end balance.
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.
c) Obtain in writing from the **management** their explanation as to why the terms obtained are **not prejudicial** to the interest of the company in those instances where better terms could have been obtained.
d) Whether receipt of the **principal** amount and **interest** are also **regular**.

e) If the **secured** loans and advances are made by the company than **check** the securities.
f) If overdue amount is **more** than rupees **one lakh**, whether reasonable steps have been taken by the company for recovery/payment of the principal and interest.
g) 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 following details: **i)** Name of the Party **ii)** Relationship with the Company **iii)** Amount **iv)** Yearend balance.
h) 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.
i) Whether **payment** of the principal amount and interest are also **regular**.

4. Internal Control
a) Obtain a **note** on the internal control system relating to **purchase** of fixed assets and inventories and for the **sale** of goods and services.
b) Whether there is an **adequate internal control system** commensurate with the size of the company and the nature of its business.
c) Whether there is a **continuing failure** to correct major weaknesses in internal control system;

5. Transaction with Parties Covered Under Register U/S. 301
a) Whether transaction that needs to be **entered** into a register in pursuance of section 301 of the act have so been entered.
b) Obtain a **written representation** from management concerning the completion of entries in the register u/s 301.
c) Whether transactions made in pursuance of such contracts or arrangements have been made at **prices** which are **reasonable** having regard to the prevailing **market prices** at the relevant time;
d) Obtain a **party wise statement** showing the following details of the transaction:
i) Purchase and sale contract reference, value and date **ii)** Purchase and selling rates
iii) Value of purchase and sale made in the year under the contract.
(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)

6. Companies Accepting Public Deposits
a) Has the company **accepted** deposits including loans from the public within the meaning of the provisions 58A and ensure that the company is not a private limited company which has restriction on acceptance of deposit.
b) Has the company **complied** with the **provision** of section 58A and 58AA and **rules** framed there under and also **guidelines** issued by the RBI?
c) If not, has the nature of contravention been **placed** on the file and accordingly **disclosed** in the report.

7. Internal Audit
In case the **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 than only the Internal audit is applicable
a) Whether the company has an **internal audit system commensurate** with its size and nature of business.
i) In the form of outside firm of CAs. **ii)** In the form of its own audit department.
b) Whether the internal **audit programme** has been **reviewed** and whether it was in the consultation with the statutory auditor.
c) Whether the **coverage** of internal audit system is **adequate**.

d) Whether the **persons** carrying out the internal audit has been properly **qualified for the job**.
e) **Factors to be considered:** The following are some of the **factors to be considered** in this regard:
What is the size of the internal audit department? In considering the adequacy of internal audit staff, it is necessary to consider the nature of the business, the number of operating points, the extent to which control is decentralized, the effectiveness of other forms of internal control, etc.
What are the qualifications of the persons who undertake the internal audit work? Internal auditing is reasonable to except that the internal audit department should normally be headed by a chartered accountant and that, depending upon the size of the department, it employs other qualified persons.
To whom does the internal auditor report? In general, the higher the level to which the internal auditor reports, the greater will be his independence.
What are the areas covered by the internal audit? Internal audit can cover a large number of areas including operational auditing, organization and methods studies, special investigations and the like.
Has the Internal auditor adequate technical assistance? This can be provided either by having full-time technically qualified persons in the internal audit department or by such persons being deputed to the internal audit department for specific assignments.
What are the reports which are submitted by the internal auditor or what other evidence is there of his work? Auditor should satisfy himself that an internal audit system is functioning effectively. He can do so by examining the reports submitted by the internal auditor.
What is the follow-up? It is necessary that there is an adequate follow-up system to ensure that the errors pointed out are corrected and remedial action taken on the deficiencies reported upon.

8. Cost Records
a) Whether the **maintenance** of cost records has been prescribed by the **central govt**.
b) Whether the records have been properly **verified**.
c) Whether the cost audit has been **prescribed** in respect of this records and if so, whether the reports have been perused.

9. Statutory Dues
a) Obtain a **statement** for 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 showing the **following details**: • Name of the Statue. • Nature of the dues. • Amount. • Date of deduction. • Due date. • Date of deposit. • Amount of deposit.
b) Verify the above obtained details with the **relevant records**.
c) If the company is **not** regular in **depositing** the above mentioned statutory dues with the appropriate authorities then 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**.
d) In case of any statutory dues have **not** been **deposited** on account of any **dispute** then obtain list of all statutory dues in the following format: • Name of the statute. • Nature of dues. • Year to which it pertains. • Amount. • Forum where dispute is pending.

10. Loss Making Companies
a) Has the company been registered for a period of **five or more years**?
b) The **accumulated loss** at the end of the financial year is not less than **fifty percent** of its **net worth**.

c) Whether the company has incurred **cash losses** in such financial year and in the immediately preceding financial year

11. Repayment of Dues

a) Obtain a **list of dues payable** during the year to:
• Financial Institutions • Bank • Debenture holders
b) List all defaults in any payment showing the period of default and amount.

12. Loan Against Securities

a) Whether the company has **granted** any loans and advance on the basis of security by way of pledge of shares and securities.
b) Whether **adequate documents** and records are **maintained** for each of such loan.
c) Whether the **shares and securities** held in the **company's name** or are in **possession** of the company - obtain **confirmation letter** from parties who have pledged the securities.
d) If proper documents or records are **not** available obtain **explanation** from the company - list of the deficiencies.

13. Chit Fund/Nidhi Or Mutual Benefit Fund/Societies

a) Whether the provisions of any **special statute** applicable to chit fund have been **duly complied** with in respect of nidhi / mutual benefit fund/societies?;
b) Whether the **net-owned funds to deposit liability ratio** is more than **1:20** as on the date of balance sheet;
c) Whether the company has complied with the **prudential norms** on income recognition and provisioning against sub-standard/ doubtful/loss assets;
d) Whether the company has **adequate procedures** for **appraisal of credit proposals** / requests, assessment of credit needs and repayment capacity of the borrowers;
e) Whether the **repayment schedule** of various loans granted by the nidhi is based on the repayment capacity of the borrower;

14. Companies Dealing in Securities

a) Is the Co. **dealing or trading** in shares, securities, debentures & other investments?
b) Whether **proper records** have been maintained of the transactions and contracts
c) Whether **timely entries** have been made therein;
d) 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;

15. Guarantee Given

a) Obtain a **list of all guarantees** given by the company on behalf of others to any bank or financial institutions showing • Loan amount • Period • Maximum liability as Guarantor • Other terms and conditions.
b) Whether any **terms and conditions** whereof are **prejudicial** to the interest of the Co.
c) Verify that **parties** on whose behalf the guarantees have been given are **financially capable** of **handling the liabilities** and if not obtain written clarification from the management.

16. End Use of Borrowings

a) If the company has obtained any term loans during the year or earlier year, obtain a **list of loans** and the **purpose** for which loan obtained as per the sanction letter.
b) Verify that the loans are **applied** for the purpose for which they were obtained.
c) If any of the loan still **remains** to be applied, whether the same has been kept **separately in bank** for future application.

17. Source & Application of Funds

a) Prepare a **Cash flow statement** showing source of fund and application of fund segregating short term fund and investment and long term fund and investment.
b) 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;
c) Whether **long term investment match** with total of **long term funds** and cash generation during the year.

18. Preferential Allotment

a) 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. Obtain the term of the issue and price at which it is issued.
b) Whether **proper resolution** has been passed and consent of **proper authority** has been obtained.
c) Whether the **price** at which shares are **issued** has been arrived after taking into account the **market value** of the shares of the company.
d) Whether the price at which shares have been issued is **prejudicial** to the **interest** of the company;

19. Security/Charge for Debentures Issued

a) Whether the company has created proper 'security' or **charge** on the assets for the debentures issued by it.
b) Where the company has issued any debentures, the auditor should also examine the **debenture trust deed** executed.
c) The auditor can examine the **relevant documents** creating the charge in **favor of the trustees** for the debentures holders.

20. End Use of Issues Proceeds

a) Whether the management has **disclosed** on the end use of money raised by **public issues** and the same has been verified;
b) The companies make such a **disclosure** in the **Board's Report**.
c) He should verify that the amount of end-use of money disclosed in the Financial Stmt. by the management is **not significantly different** from the proposed and actual end-use.
d) The auditor should obtain a **representation** from the **management** as to completeness of the disclosure with regard to the end-use of money raised by public issues.

21. Fraud

a) 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.
b) Whether **full investigation** has been carried out to discover the fraud.
c) Whether the company has filed any complaint with the police or **criminal case** registered against any person for any fraud committed.
d) Whether any **other party** has filed any **complaint** or criminal case registered against the company for any fraud or cheating.
e) Whether any time during the year or period of audit any report of fraud committed by the company **reported in press** has been noticed?

iv) Reasons To Be Stated For Unfavorable Or Qualified Answers –

a. Where, the auditor's report, the **answer** to any of the questions referred to in paragraph 4 is **unfavorable or qualified**, the auditor's report shall also state the **reasons** for such unfavorable or qualified answer, as the case may be.

b. 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.

8.4 Qualifications In The Auditor's Report - According to section 227 (4) of the Companies Act, 1956, the auditor should give reasons for any qualifications or reservations in his report. According to statements, a qualified report is not necessary unless the issues involved are material. The Council of the ICAI has also published the **"Statement on Qualifications in the Auditor's Report'** which enumerates some principles regarding the purpose and manner of any qualification in the Auditor's Report.

i) Aspects to Be Considered In Qualifying A Report

a. Auditor should identify **statements of facts and opinions**, which require qualification.
b. Where the auditor is in active **disagreement** with something, which the management had done he would either give an **adverse report or disclaim his opinion**.
c. Where the **disagreement** with the management is only in respect of a **particular item**, he may **qualify** his report.
d. Where the matter in question are so **material** enough as to **effect** the presentation of **true and fair view** of state of affairs of Co., he may give an **adverse** opinion.
e. Where the item concerned is **not material**, he may even ignore the aspect and issue a **clean report**. It may so happen that items, which individually do not affect the true and fair view of the accounts, **distort** the true and fair view if taken **together**. In such cases the auditor should state that FS do not reflect a true and fair view.
f. The auditor should also give **complete information** about the subject matter of the **qualification** and should avoid any vague statement.

ii) Manner Of Qualifying The Reports - The auditor should consider the following principles while qualifying his report.
a. All the qualifications should be contained in the auditor's report. The notes to accounts normally represent explanatory statement given by the director of the company. Where some of the **notes** on accounts are of a **qualificatory nature**, the auditor should make an adequate **reference** of those in his report also.
b. The auditor should **quantify**, wherever possible, the **individual** as well as the **total effect** of all the qualifications on the profit and loss account or balance sheet of the company. In circumstances where it is not possible to quantify the effect of the qualifications accurately the auditor may do on the estimates made by the management.
c. The auditor should use the recognized terminology while making qualificatory statements. For example, **"subject to", "except that"**.
d. In case the company has **violated a legal provision**, the auditor should **qualify** his report irrespective of the fact whether the company takes corrective action either before, or after the close of the accounting period.
e. Where the **directors** or **management** of the company was **involved** in any **fraud** committed against the company, the auditor should state the fact is his report.
f. Where **personal expenses** of the directors have been **charged to revenue** of the company, auditor should qualify report even though the amount involved is not material.
g. The **Institute has recommended** that the auditors should **not** make their **main report subject to** a **detailed report** unless the circumstances make such reports necessary. In case separate reports are issued, the auditor should address them to the shareholders rather than to the management.
h. The auditor should **not include** in his report any **explanation** offered to him by the **management** in respect of the qualifications.
i) It is recommended that auditor should **discuss** his report with **management**. This will give the management an opportunity to explain the qualifications in the auditor's report. He

may also gain better insight of other important areas which may have been ignored by him.
j) He should **not qualify** his report referring to any **earlier periods**' FS.
k) The auditor **cannot refer** in his report anything contained in the **director's report**. This is because directors' report is prepared after the auditors' report has been received.
l) The **directors** of the company are obliged to **explain** all the **qualifications** made by the auditor vide their report to the shareholders under section 217 of the Companies Act, 1956. Further, the management should also explain the **adverse comments**, not in the nature of qualifications, issued by the auditor. For example, delay in payment of P.F. dues to the trust. However, the directors of a government company are not obliged to provide explanations to any adverse comments made in the C&AG's audit report.
m) The auditor should also include in his report the **qualifications** in the **branch auditor's report** unless: • The objects of the branch auditor have been met while preparing the accounts of the company; or • The qualification is not material at the company level; or • The management has explained the qualifications satisfying the auditor that the same are not required.

8.5 Auditor's Separate Report To Directors
i) The **management** of the company may require from the auditor a separate report **in addition** to his report under section 227 of the Act.
ii) The **objective** of such reports is to provide the management with **detailed information** regarding **procedures, systems, weaknesses in internal controls** etc. to enable the management to exercise greater degree of control over the business operations.
iii) The reports should be detailed enough to **highlight** the **weakness and suggestions** to improve upon them.
iv) The auditor should take care that matters, which are **material** enough to be **reported** to the **shareholders** are **not** contained in his report to the directors.
v) The **nature of the facts**, their **materiality** and their bearing upon the truth and fairness of the accounts should be the governing factor. There is no clear-cut distinction between facts, which should be reported to the shareholders and those to the directors. This has to be determined by the auditor based on his personal judgment.

8.6 Audit Certificates And Audit Report
i) A **'certificate'** is a **written confirmation** of the accuracy of the facts stated therein and does **not** involve any **estimate or opinion**.
ii) The auditor may be called upon to **certify** the consumption of raw materials or the **export** of goods manufactured by the entity.
iii) The auditor's certificate **represents** that he has **verified** certain figures and is satisfied about their accuracy.
iv) A **'report'** is a **formal statement** made after an enquiry or examination of the **specified matters** under the report and the auditor's opinion thereon.
v) The reporting auditor should **exercise due care and skill** while examining the facts and form his opinion based upon them.
vi) The **opinion may differ** from one auditor to another as it involves personal judgment.

8.7 Audit Reports And Certificates For Special Purposes - Often the auditor is called upon to issue **special reports** and certificates **in addition** to the general-purpose report. The Institute has issued a "**Guidance Note on Audit of special certificates and reports"**. The following aspects should be considered while preparing audit reports and certificates for special purpose.

i) Responsibility
a. The responsibility for preparation of special purpose certificates **lies** with **management**.

b. The auditor is **responsible** only **to check the contents** of certificate & issue a report thereon.
c. These certificates may be **audited either** by the **statutory auditor** of the company or **another** CA. The appointment is to be made by the management.
d. In case of **prospectus** and **other statutory reports**, only the **statutory auditor** of the company should **sign** the certificates.
e. The auditor may **not** be a **technical expert** in all areas; thus, he may have to rely on the opinion of other **experts**. The **report** of the auditor should **clearly** bring out such **reliance** and any other limitation in the scope of his audit.

ii) Contents of Special Purpose Reports - Normally, a reporting auditor can choose the forms and contents of his report. In the case of statutory certificates or reports, the contents are specified in the relevant statute itself. In other cases, ICAI recommends the following contents.
a. Title of the statement should indicate whether it is a report or certificate.
b. The **amount of transaction or account** should be clearly identified and stated.
c. Limitation on scope of work of the auditor, if any, should be stated.
d. The extent of **responsibility owned** by the **auditor**.
e. The **assumptions used** in the conduct of the audit.
f. Nature of the audit tests performed.
g. A statement that he is **merely expressing** his **opinion** should be made in case the report requires interpretation of statute.
h. The extent of **reliance** that has been **placed** on the work of an **expert**.
i. A **statement** that the **general purpose report** was **referred** to and in the case of non-availability of the same, the fact shall be indicated.

iii) Addressing Of The Report - The report or certificate is generally addressed to the **client or** the person requiring the certificate. In case the certificate is issued without any reference to a person, the auditor may use the words **"To whomsoever it may concern"**.

8.8 Audit Of Company Prospectus - 'Prospectus' means any document described or issued as a prospectus and **includes** any **notice, circular, advertisement or other document inviting deposits** from the public or inviting offers from the public for the subscription or purchase of any shares in, or debentures of a body corporate (Section 2 (36) of the Companies Act, 1956). In order to protect the investors from deceiving offers, the Companies Act has specified certain information/Reports etc to be furnished in detail in the prospectuses:

i) Reports To Supplement The Prospectus - Two reports on financial aspects to be included in a prospectus are:
a. Reports of the **statutory auditor or joint auditors** of the company; and
b. Report of the **accountant**. A person who is eligible to be appointed as an auditor shall be qualified to act as an accountant.

ii) Aspects Concerning The Auditor
a. Signing of the Report - The requirements of signing of these reports are **same** as in case of **signing of audit report** under the Companies Act, 1956.
b. Fees for Issue of reports – It is determined on the basis of **agreement** between the auditor and the directors of the company.
c. Communication of the report - The reports of auditors are addressed to the **Board of Directors** of the company.
d. Consent Letters - The auditor should give **in writing** his consent to act in such capacity. The letter should accompany the prospectus when submitted for registration.

e. Rights of the auditors - The auditors have right to **access the books of account**, other records and call for any necessary information from the company.
f. Liability for misstatements in prospectus - According to section 62 of the Companies Act, 1956 **every person** who has **authorized** the issue of prospectus will be liable to **compensate** every person who has incurred any loss or damage due to untrue statement in the prospectus. Section 60(3) provides that **CAs** will be liable only for untrue statements made by them in the capacity of **expert**. Where the auditor is made to compensate for any loss, he may claim contribution from other persons.
g. A professional accountant will not be so liable if he can prove that:
• Prospectus was issued **without his knowledge or consent** & that on becoming aware of its issue, he gave reasonable public notice that it was issued without his consent; or
• He **withdrew** his **consent in writing before delivery** of prospectus for registration; or
• **after delivery** of prospectus for registration **but before allotment of shares**, on becoming aware of the untrue statement, he withdrew his consent in writing and gave reasonable public notice of the withdrawal and of the reasons therefore; or
• He was competent to make statement & he had **reasonable ground to believe** & did **up to the time of allotment** of shares or debentures believe that the statement was true.
iii) Aspects Concerning the Accountant
The reporting accountant are required to **report** on the profits and losses for the **preceding five years** and on the position of assets and liabilities. He should separately disclose items of extra ordinary nature in the profit statement. He may also have to **adjust the figures** in income statement on the following grounds:
a. All **prior period items** should be **adjusted** in the year to which they **relate** and not in the year in which they came to be known;
b. Where **accounting policies** have **not** been consistently **followed**, the accountant should compute the figures for all periods under report based on the policies applied in the latest period.
c. All items of **material nature** which is **not** likely to recur should be **adjusted** in the preparation of **profit trend statement**, such items may be • Heavy repairs and renovation; or • Discontinued operations / businesses; or • Abnormal losses
d. Where the statement of **trend of profits** contains an **interim period** or broken period, the accountant may adopt either of the two approaches:
• He may **treat** the **interim period** as **part** of the **whole year**. In this case, the items of the income and expenditure should be based on the yearly trend for the period covered by the report; or • He may **view** the **interim period** as a **separate accounting period** and items of income and expenditure will be reported at actual for the period. Similar will be the treatment for estimated provisions in the accounts.

8.9 Audit Reports / Certificates On Financial Information In Offer Documents

All financial information **forming part of offer documents** shall be **audited**. The following are the various financial information which form parts of offer documents. (Para 4 of Part A-i of clarification XIV)

i) Auditor's Report - The offer document should include Auditor's Report on the profit and loss statement for the **five years** immediately preceding the issue of prospectus and on the assets and liabilities as on the date of issue of prospectus.

ii) Adjustments In Statement Of Profit Or Loss And Assets And Liabilities:
Clause 20 of Part III of Schedule II to the Companies Act, 1956 requires that "any report required under Part II of this schedule shall either
a. Indicate by way of **note** any **adjustments** as regards the figures of any profits or losses or assets and liabilities dealt with by the report which appear to the persons making the report necessary or

b. Make those adjustments and indicate the fact that the **adjustments** have been **made**. Where there is a **qualification** by the **auditor** with regard to statement of profit or loss, assets and liabilities, all adjustments shall be made in the respective statements itself.

iii) General Considerations:
a. The auditor should obtain from the management of the issuer company the **adjusted statements** of profit or loss and assets and liabilities, as approved by BOD.
b. Detailed notes showing the manner of arriving at the figures should support the statements.
c. The auditor should examine the **audited accounts**, the adjusted statements and the detailed notes prepared by the management regarding the **required adjustments** and **make** such **further adjustments** as deemed necessary by him.
d. Adjustments should also be made for the purpose of presenting aforesaid financial information of the **subsidiaries**.
e. The **adjustments** are subject to the **concept of materiality** which is defined in AS-1 on "Disclosure of Accounting Policies".
f. The adjustments in the statements of profit or loss, assets and liabilities would also have to be made in respect of **adjustments for previous year** and **changes in accounting policies** even if they do not form part of qualification in the report of the auditors.
g. Adjustments which may arise consequent to **qualification** by auditor, previous year's adjustments and changes/incorrect accounting policies, may not be made unless the impact is **material** to render the data meaningless.

iv) Adjustments Arising Out Of Qualification In Auditor's Report
a. Where the auditor has made qualification due to **incorrect accounting practices** and **failure to make provisions** or for any other reason, necessary adjustments should be made in the financial information of respective period.
b. Where it is **not** possible to make **adjustments/rectification**, it should be specifically stated and the exact text of qualification should be reproduced by way of a note.
c. Adjusted/rectified statements for the **5 financial years immediately preceding the issue of prospectus** should be prepared after considering the qualification made by the auditor only in respect of those financial years.
d. Where the qualification has an impact on the FS, of **two periods**, then the **adjustment** shall be **effected** in the **FS** of **both the years**. e.g. adjustment relating to valuation of closing stock.
e. It is possible that the auditor may have made a **qualification** in a particular period on the basis of **availability of information** at the time of finalization of audit report. However, based on **subsequent development** and availability of information the qualification may become unnecessary. In such a case no adjustment should be made in the statement of profit or loss.

v) Adjustments Relating To Previous Years - Adjustments related to previous years should be made in **arriving** at the **profits** of the **years** to which they **relate** irrespective of the **years** in which the **event has occurred**.
There are two constituents of previous year's items
a. Prior period items (AS-5)
b. Material adjustments necessitated by circumstances which though **related to previous periods** are **determined** in the **current period** e.g. creation of liability due to retrospective amendment of law and price fixation of a product with retrospective effect.

vi) Changes In Accounting Policy - The impact of the change in the accounting policy should be made with **retrospective effect** over the five years period. Where it is **not possible** to restate the figures of profit or loss / assets and liabilities, the auditor may state

the **fact** and provide the **reasons** also.

vii) Incorrect Accounting Policies - In case an incorrect accounting policy is being followed, the **re-computation** of the FS should be in accordance with correct accounting policy.

viii) Extraordinary Items - Profit or loss arrived at before and after considering the extraordinary items should be **disclosed** on **"net of tax basis".**

ix) Material Changes in Activities - The offer documents shall also disclose the changes in the activities of the issuer, which may have had a **material effect** on the FS. For example,
a. Discontinuance of lines of business.
b. Loss of agencies or market and other similar factors.
c. Addition of new lines of business.

The **management** shall prepare the statement disclosing the above. The auditor should **check** the correctness of the information based on his knowledge of the company's operations. In the case of **discontinued operation** the following information shall be disclosed.
a. Nature of the discontinued operation
b. Effective **date** of discontinuance for the accounting purposes.
c. Manner of discontinuance (sale / abandonment etc.)
d. Turnover of the discontinued operation

x) Significant Accounting Policies - All significant accounting policies followed in the preparation of offer document should be disclosed.

xi) Transactions with Companies in "Promoter Group" - Disclosure in offer document is called for in respect of
a. Sales or purchases between companies in the **'promoter group'*** when sales or purchases exceed in value, in aggregate, 10% of the sales or purchases of the issuer.
b. Material items of income or expenditure arising out of transactions within the promoter group.
***'Promoter group' means and includes i)** Promoter, **ii)** An immediate relative of the promoter, and **iii)** Where the promoter is a body corporate: **(a)** a subsidiary/holding Co. of that body. **(b)** Any Co. in which the promoter holds 10% or more of the equity capital or which holds 10% or more of the equity capital of the promoter. **(c)** Any corporate body in which group of individuals or bodies corporate or combination thereof which hold 20% or more of the equity capital in that company also hold 20% or more of the equity capital of the issuer company.
"Promoter" means
i) the person or persons who are in over all control of the company.
ii) The person or persons who are instrumental in formulation of a plan or programme pursuant to which the securities are offered to the public
iii) the person or persons named in the prospectus as promoters.
Auditor's Duty - The auditor should:
i) obtain from the **management information** on names, address, and relevant transactions etc. with "promoter or promoter group"
ii) Review the evidence in the light of CARO, 2003.

xii) Disclosure Under The Heading "Other Income" - Where such income exceeds 20% of net profit before tax the various details of "other income" shall be disclosed: **a.** Source;

b. Nature; **c.** Amount; **d.** Recurring or non recurring; and **e.** Whether on account of normal business activity or not

xiii) Disclosure of Bifurcated Turnover
a. Turnover of products **manufactured** by the company
b. Turnover of products **traded** by the company and
c. Details of products **not normally dealt** in by the company but included in above should be mentioned separately.

xiv) Statement of Assets and Liabilities - The statement of assets and liabilities should be prepared after **deducting** the amount of **revaluation reserve** from both fixed assets and reserves and the net Worth after such deduction.

xv) Financial Information to be Contained in the Report of an Accountant - This point has already been discussed under "Audit of Company Prospectus".

xvi) Financial Information in Respect of which the Auditor should give Separate Report to the Management - There is some other financial information that should be provided by the management and the same should be audited by the auditor of the issuer company. The report should also be contained in the offer documents.
a. Tax Shelters - For proper understanding of future maintainable profits, the incidence of tax should be properly explained by way of appropriate disclosure.
b. Accounting Ratios - The following accounting ratios for each of the accounting periods for which financial information is given:
• **Earnings Per Share**
It may be **(i)** basic earnings per share or **(ii)** diluted earnings per share.

→**Basic Earnings Per Share =**

$$\frac{\text{Net profit/loss for the period attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the period}}$$

→**Diluted Earnings Per Share =**

$$\frac{\text{Net profit attributable to equity shareholders (After adjustment for diluted earnings)}}{\text{Average number of weighted equity shares Outstanding during the period (assuming The conversion of diluted potential equity shares)}}$$

• **Return On Net Worth**
The formula used is

$$\frac{\text{Net profit before extraordinary items but after adjusted tax}}{\text{Net worth excluding revaluation reserve at the end of the year}} \times 100$$

The term adjusted tax refers to tax provided for the period after adjusting tax attributable to extraordinary items. While calculating net worth, the effect of revaluation should be ignored. In order words, the assets would be valued on historical cost basis.

• **Net Assets Value Per Share**
a. NAV shall be calculated on the basis of the **latest audited balance sheet**.
b. It can be computed either by **net assets method** or **net equity method**.
c. In the case of 'net asset method' the total liabilities and preference capital are deducted from the total assets.
d. In the case of 'net equity method', equity share capital is added to reserves and surplus, deducting there from miscellaneous expenditure and debit balance of profit and loss account.
e. The auditor should **consider Intangible assets** are not taken into account (unless they have been paid for), **Revaluation** of assets has not been taking into account, **Arrears** of preference dividend should be provided for.
→The formula for NAV per share is

$$\frac{\text{Net Asset Value}}{\text{Equity shares at the end of the accounting period}}$$

The auditor should satisfy himself that for making various computations for the above accounting ratios, the various items of profit/loss, assets & liabilities have been properly adjusted.

xvii) Capitalization Statement - The capitalization statement shows total debt and net worth and the debt / equity ratio before and after the issue is made. Where there is a **change in the share capital** since the date as of which the financial information has been disclosed in the offer document, a **note** shall be included explaining the nature of change. While calculating the debt / equity ratio auditor should consider the following:
a. Debt means long-term debt e.g. debenture bonds, long-term loans from institutions.
b. Preference capital is considered as equity; unless it is to be repaid shortly.
c. Convertible debentures and other loans have been considered as equity.
d. "Equity" -includes paid up capital of equity and preference, reserves and surplus after deducting miscellaneous expenditure and debit balance in profit and loss account.
e. The debt equity ratio shall be **calculated separately** for • pre-issue and • post-issue

xviii) Disclosure of Project Expenditure - The following information should be annexed to the Offer Document:
a. Actual expenditure incurred on the project up to a date not earlier than 2 months of filling the prospectus with SEBI or ROC, whichever is later
b. Means and sources of financing such expenditure.
c. Year wise breakup of the expenditure proposed to be incurred on the said project.
The auditor should obtain a **management representation** regarding details of project expenditure and the means and sources of financing such expenditure and year-wise break-up of expenditure proposed to be incurred on the project. There is no need to audit the information as it is based on estimates arrived at by management.

xix) Bridge Loans - Details of bridge loans or other financial arrangement if any for incurring expenditure on project and which would be repaid from the proceeds of the issue.

xx) Loans - The **principal terms** of loans and assets charged as security should be disclosed.

xxi) Disclosure under "Basic of Issue Price" - The following information shall be disclosed
a. • **EPS** i.e. EPS pre-issue for the last three years (adjusted for changes in capital) • **P/E**

pre-issue - comparison with P/E of industry (giving source of information) • **Average return on net worth** in the last three years • **Minimum return** on increased net worth required maintaining pre-issue EPS. • **NAV** per share after issue and comparison thereof with the issue price.
b. The **accounting ratios** shall be calculated after giving effect to the consequent increase in capital on account of compulsory conversions outstanding as well as on the assumption that the options outstanding, if any, to subscribe for additional capital will be exercised.

xxii) Auditor's Certificate on Profit Forecast - The offer documents should also include a forecast of
a. estimated profits for the financial year ending immediately before the date of offer document (if such information is not already given in the offer document) and
b. for the financial year ending immediately after the date of the offer documents. This should be supported by an **auditor's certificate**, which lists the **major assumptions** on which the forecast is based and gives assurance on the arithmetical calculations derived from such assumptions.

Exception - The above disclosure are not required if:
a. the company has made **projections of future profits** in line with clarification XIII of SEBI guidelines which include projected profits for the above period or
b. the company has **not commenced commercial production**.
• The management is responsible for preparation of forecast.
• The BOD should also approve it.
• The auditor should obtain list of assumptions on the basis of which the forecast is made.
• The auditor should only satisfy himself that the figures in the profit forecast have been arrived at one the basis of the assumptions stated by the directors.
• While the auditor is not required to look into the propriety of assumptions, yet where the assumptions are prima-facie irrational, the auditor may advise the management to revise the forecast.
• Unless the forecast is revised, the auditor may consider either not issuing the certificate or stating in his certificate his perception about the assumptions.

8.10 Report In Case Of Voluntary Winding Up - Section 488(1) of the Act requires that where it is proposed to wind up a company voluntarily, its directors, or in case the company has more than two directors, the majority of the directors, may at a meeting of the Board, make a declaration verified by an affidavit, to the effect that they have made a full inquiry into the affairs of the company, and that, having done so, they have formed the opinion that the company has no debts, or that it will be able to pay its debts in full within such period not exceeding three years from the commencement of the winding up as may be specified in the declaration. Such declaration has to be accompanied by a copy of the report of the auditors of the company (prepared, as far as circumstances admit, in accordance with the provisions of this Act) on the profit and loss account of the company for the period commencing from the date up to which the last such account was prepared and ending with the latest practicable date immediately before the making of the declaration and the balance sheet of the company made out as on the last mentioned date and also embodies a statement of the company's assets and liabilities as at the date.

CASE STUDIES

Q1. ABC Company has defaulted in compliance of section 58AA of the Companies Act, 1956 with regard to public deposits. Discuss, what are the reporting requirements under the Companies (Auditor's report) Order, 2003 for ABC Company?
Hint Ans: Refer Point No. 8.3–C–iii-6

Q2. As the statutory auditor of B Ltd. to whom CARO, 2003 is applicable, how would you report in the following situations?
(a) The company has stood guarantee to its sister concern, whose financial condition was not healthy for a sum of Rs. 20 lakhs borrowed from a bank.
(b) Physical verification of only 50% (in value) of items of inventory has been conducted by the company. The balance 50% will be conducted in next year due to lack of time and resources.
(c) Accumulated losses of the company are 50.9% of its net worth and it is incurring continuous cash losses since last 2 years.
Hint Ans: (a) Refer Point No. 8.3–C–iii-15; in this case, since financial condition of the company on behalf of whom guarantee is given is not so good, the auditor may consider expressing an opinion that the terms and conditions on which the company has given guarantees for loans taken by the sister concern, i.e., M/s B Ltd., is prejudicial to the interests of the company.
(b) Refer Point No. 8.3–C–iii-2(a); in the given case, the above requirement of CARO, 2003 has not been fulfilled as such and the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable. He may consider the impact on FS and report accordingly.
(c) Refer Point No. 8.3–C–iii-10; in the instant case, since the company is covered by the above requirements, there are symptoms of potential sickness and, thus, auditor should report the same. It is, however, to be assumed that the company is in existence for more than 5 years.

Q3. 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, Customs duty, Excise duty, Cess and any other statutory dues with the appropriate authorities and if not, the extent of 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.
Hint Ans: Refer Point No. 8.3–C–iii-9

Q4. As a Statutory Auditor, how would you report on the following under CARO?
(a) O Pvt. Ltd. Is a dealer in Shares and Securities
(b) ABC Pvt. Ltd is a Manufacturer of jewellery. A senior employee of the Company informed you that the Company does not properly disclose the purity of gold used on the jewellery.
Hint Ans: (a) Refer Point No. 8.3–C–iii-14
(b) In the case of ABC Pvt. Ltd. If purity of gold is not properly disclosed on the jewellery it amounts to defrauding the customers. That means the management is **deceiving customers** to obtain an illegal advantage. However, the auditor is concerned with **fraudulent acts that cause a material misstatement in financial statements**. As long as books of account are not falsified arising out of difference in the purity of gold, i.e., actual cost of the gold and the sale price of gold, it has no implication for the auditor. Further, under **CARO, 2003**, the auditor may examine this from the view point of maintaining proper records of inventory. But even the requirement of maintaining proper records do not necessitate that purity as such should be mentioned on the gold itself. However, the purity of gold would have implication on the valuation of inventory. But this aspect is not required to be reported under CARO, 2003.
Thus, from the view point of reporting on frauds under CARO, 2003, there is no implication for misstatement in the FS. Hence, no reporting is necessary for non-proper disclosure of purity of gold on the jewelry.

Q5. (a) Under CARO how as a statutory auditor would you comment on the following?
(i) Fixed assets comprising 1/3rd of the total assets have been disposed off during the year.
(ii) A Term Loan was obtained from a bank for Rs. 75 lakhs for acquiring R&D equipment, out of which Rs. 12 lakhs was used to buy a car for use of the concerned director, who was looking after the R&D activities.
(b) There is non-provision in the accounts of a limited company in respect of gratuity liability and auditor's report thereon is silent.
Hint Ans: (a)(i) Refer Point No. 8.3–C–iii-1(d); in the instant case, the auditor should satisfy himself as to whether disposal off of 1/3rd of fixed assets during the year had any effect on the going concern assumption on account of such sale of fixed assets. The auditor is required to exercise his professional judgement to determine whether disposal off of one-third of total assets constitutes substantial part or not. Depending upon the judgement arrived at by the auditor, he shall report whether substantial part of fixed assets have been disposed off or not during the year and it has affected or not affected the going concern status of the company. Alternatively, in case the auditor is of the opinion that it constitutes substantial sale but the going concern assumption is appropriate because of mitigating factors then he has to ensure that the same are disclosed in the FS or else he shall have to modify the auditor report. The manner of reporting shall also be modified appropriately in case the going concern assumption is resolved or not.
(ii) Refer Point No. 8.3–C–iii-16(b) & (c); in the instant case, The auditor should state the fact in his report that the out of term loan of R&D Rs. 12 lakhs was not utilised for the purpose of acquiring the R & D equipment.
(b) Section 209(3) states that a company shall not be deemed to be maintaining proper books of account in case such books are not kept on accrual basis, according to the double entry system of accounting. If no provision is made, a note should be given on the accounts disclosing the total accrued liability of gratuity and the amount not provided for, otherwise the auditor should qualify his report. Accordingly, the auditor should include this paragraph in his report to qualify true and fair view of both the balance sheet and the profit and loss account. Failure of the management to quantify the amount of the liability by resorting profit to actuarial valuation should also be included in the qualification

Q6. As CA you are required to give your reports on various FS under Companies Act, 1956 which are as under:
(i) Report to the shareholders under Section 227;
(ii) Report to be set out in prospectus under Section 60(3);
(iii) Report to be given on voluntary winding up under Section 488(1).
Explain the significance of each of these reports and your functional approach very briefly.
Hint Ans: Auditor's report on the Companies Act, 1956 (the Act)
(i) Refer Point No. 8.3–B(a)
(ii) Refer Point No. 8.8-(i)
(iii) Refer Point No. 8.10

Q7. The auditor of a company has qualified his report because of non-availability of information about a customer from whom large sums of money were due to the company and also because the account remained non-operative for a period exceeding three years. What is your opinion?
Hint Ans: Section 227(3) (a) of the Companies Act, 1956, lays down that "The auditor's report shall state whether he has obtained all the information and explanation which to the best of his knowledge and belief were necessary for the purpose of his audit". In the instant case, the auditor has not been provided with information about a material recoverable account and as such he is required to qualify the affirmation required under Section 227(3)(a) of the Companies Act, 1956, and on whether balance sheet and the profit and loss account are true and fair. Even if the amount is shown as doubtful or bad in the balance

sheet, but not provided for the auditor is required to qualify his opinion as regards the true and fair view and to quantify its impact on the balance sheet and the profit and loss of the company, more so when the recovery of the debt has become statue barred.

Q8. X and Y the directors of ABC Ltd., a woolen manufacturing company, are the shareholders of DEF Ltd. and XYZ Pvt. Ltd., ABC Ltd. during the accounting year ending 30.6.2002 has made an advance of Rs. 20 lakhs to DEF Pvt. Ltd. and Rs. 15 Lakhs to XYZ Pvt. Ltd. No approval of central Government was obtained as per Section 295 of the Companies Act, 1956. Auditors to the directors who after the close of the year but before finalization of accounts collected the loans from the respective companies notified this fact. Necessary note regarding the contravention of the legal provision was made in the accounts. Do you think the auditor should qualify his report? Will your answer be different in the case contravention of law is rectified before the date of the balance sheet either by obtaining Central Government's sanction or by calling back the loans from the companies.
Hint Ans: Qualification by the auditor is a must because there is a violation of Section 295 of the Companies Act, 1956. The fact that the company provides a note in the accounts does not discharge the auditor from his responsibility to quality the audit report. The answer will not be different even if the company has corrected the position by calling back the 'loans and advances' or obtaining Central Government's sanction prior to the close of the period because true and fair view is vitiated as soon as the violation in the law has taken place. In effect, subsequent correction does not alter the stand of the auditor.

Q9. Hopeless Ltd. held its annual general meeting on 31.3.2002 when the accounts for the year ended 30.9.2001 could not be placed as the auditor's report was not received by the date. The agenda included re-appointment of auditors and they were duly re-appointed. The next AGM was held on 10.3.2003 when the accounts for the year ended 30.9.2002 was not placed as auditor's report was not received by the date. In the same meeting the auditors were removed the new auditors were appointed. The annual general meeting was adjourned to a later date. In this regard –
I. Can the management lay the un-audited annual accounts for the year ended 30.9.2001 and 30.9.2002 in the adjourned AGM?
II. Can the company conclude its AGM without laying the annual account before it?
Hint Ans: Hopeless Ltd. cannot lay the un-audited FS in the AGM because the intention of the law is that audited accounts should be adopted by the shareholders. Hopeless Ltd. can conclude the AGM without laying the annual accounts provided the reasons for such situations are clearly mentioned to CG and the latter's approval is obtained. The contention of the retiring auditors is incorrect because the term of office of an auditor, according to Section 224 of the Companies Act, 1956, covers the period between 2 AGMs. Hence, the new auditor is obliged to report on the accounts relating to the years 2001 and 2002 also. However, the auditor may seek additional time to check the accounts of those years. In any case, without confirming the opening balance on 1.10.02 it is not possible for the new auditor to express opinion on the accounts for 2002-03.

Q10. The following balances were standing in the books of Indian Oil Corporation Ltd. as at 30.9.2002 in respect of advances made to contractors and suppliers.

Jay contractors	Rs. 20, 00,000.00
Mac Engineers & Contractors	Rs. 25, 00,000.00

	Rs. 45, 00,000.00

The directors seek your advice whether these advances can be disclosed as capital work-in-progress. Advise the directors.
Hint Ans: On the basis of the facts disclosed in the problem a company cannot show the

advances as capital work-in- progress because for such a treatment the original invoices and evidences with regard to completion of the work should be made available. Since it is not available, the advances to contractors amounting to Rs. 45 lakhs shall be disclosed as "Loans and Advances" on the assets side of the balance sheet.

Q11. Abhay Plastics Ltd. has a Managing Director and two whole time directors. The Managing Director is the foreign national who visits India off and on. The whole time directors and the secretary authenticated the financial statement for the year-ended 31.12.2002. A note was given on the accounts explaining the reason why Managing Director did not sign the accounts. In your view, can statutory auditors raise an objection in this regard?
Hint Ans: The statutory auditor cannot raise any objection in this regard, because there is no violation of Section 215 of the Companies Act, 1956. In fact, the company has complied with Section 215 by providing a note. Hence the authentication by the whole time director is valid. The objection of statutory auditor is not tenable.

Q12. N Ltd. had made protests against income tax liability on certain ground which was not prima facie bonafide. What should be the manner of disclosure of these liabilities? Will your answer be different in case the liabilities have been contested on bonafide grounds? In your opinion should the liabilities be taken into account while considering the question of declaration of dividend as per section 205 of the Companies Act, 1956?
Hint Ans: Where the income tax liability has been contested not on bonafide grounds it does not fall within the word contingent liabilities but is a real liability. As such, the answer will be different if they have been contested on bonafide grounds because in such case they have to be disclosed as a footnote in the accounts as contingent liability. Where the liabilities are actually provided in the accounts they should be considered while arriving at the profit for declaration of dividend.

Q13. As the Statutory Auditor of a Manufacturing Company, what are the points you will consider to conclude "Whether the company has an Internal Audit system commensurate".
Hint Ans: Refer to Point No. 8.3-C-7(e)
This clause has mandatory application in case of companies having a paid-up capital and reserves exceeding rupees 50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crores rupees for a period of three consecutive financial years immediately preceding the financial year concerned. This clause is also mandatory applicable for the listed companies irrespective of the size of paid-up capital and reserves or turnover.

Q14. T Pvt. Ltd.'s paid up Capital & Reserves are less than Rs. 50 Lakhs and it has no outstanding loan exceeding Rs. 25 lakhs from any bank or financial Institution. Its sales are Rs. 6 crores before deducting Trade discount Rs. 10 lakhs and Sales returns Rs. 95 Lakhs. The services rendered by the company amounted to Rs. 10 Lakhs. The company contends that reporting under Companies Auditor's Reports
Order (CARO) is not applicable. Discuss. Nov. 2007
Hint Ans: Since paid up capital and reserves of T Pvt. Ltd. is less than Rs. 50 lakhs and has no loan outstanding exceeding rupees 25 Lakhs from any bank or financial institution, the only other condition is whether turnover exceeds rupees five crores. Turnover is not defined in the CARO. Part II of Schedule VI defines the term "turnover" as the aggregate amount for which sales are affected by the company. "Sales affected" would include sale of goods as well as services rendered by the company.
For ascertaining turnover though trade discount and sales returns should be deducted, the inclusion of services rendered would result in a turnover of Rs. 5.05 crores (i.e. 6 - 0.10 - 0.95 + 0.10 crore) Hence CARO will apply to T Pvt. Ltd.

Q15. X & Co. are the auditors of XYZ Ltd. a government company. The C&AG, in the course of audit have point out errors in the accounts which had escaped the attention of X & Co. In most cases, the company assured C&AG that necessary corrections would be made in the succeeding years. In few areas the errors were rectified and consequently the financial statements underwent changes. When the revised accounts were submitted to X & Co. for rectification, they insisted on correcting the financial statements for all the errors (including the ones for which the company has agreed to adjust in the subsequent years. Is the contention of X & Co. valid?
Hint Ans: The validity of the contention of X & Co. depends on the concept of materiality. If the errors, which the company has agreed to correct in subsequent periods, are having material impact then the same may be adjusted as contended by X & Co because it may affect the true and fair view. On the other hand, if the errors do not have any impact on the true and fair view disclosed by financial statements there is no need for correcting the financial statement in which case the contention of X & Co. will not be valid.

Q16. The Statutory auditors of Getwell Ltd. included certain comments in his report u/s 227 of the Companies Act, 1956. Since the company requested the auditors to drop the above comments, as otherwise it will affect their future business, as a compromise the auditor included the comment in the report in ordinary type. (Nov. 2008) (New Course)
Hint Ans: As per Section 227 (3) (e) of the Companies Act, 1956, one of the issues relating to audit report is that the report shall indicate in Bold or in Italics the observations as comments of the auditor which have any adverse effect on the functioning of the company. According to the Guidance Note issued clause (e) of the sub-section creates a requirement for the auditor to consider any matter leading to the modification of the auditor report on financial statements is likely to have an adverse effect on the functioning of the company and if so the auditors is required to highlight such matter in Bold or in Italics.
In the instant case, the auditor's action in having printed certain comments in ordinary type is contrary to the provision of the Act and Guidance Note. He will be deemed to have discharged his duties negligently.

Q17. D Ltd. has been making-substantial losses during the last few years. The losses have been set off against the available revenue reserves, which are now exhausted. The balance of the excess of the debit balance of the profit and loss account is now sought by the company to be set off against the capital reserves, which have resulted out of the excess of the sale price received by the company on the sale of its fixed assets over the original cost. Do you, as auditor of the company, agree with the proposed treatment?
Hint Ans: The proposed treatment of setting of the accumulated losses in the form of debit balances in profit and loss account is not in accordance with **Schedule VI** requirements, because only the uncommitted reserves can be used for setting of such losses. In this connection the company should comply with the following conditions.
1. The Articles of Association should contain a provision in this regard.
2. The profit should have been realized in cash
3. The other assets and liabilities should be revalued and any loss on such revaluation should be set off against the profits thus arrives at and the balance, if any, shall be available for dividend purposes.

Q18. As an auditor, how would you deal with the following?
a) In the audit of ABC Private Limited, auditor came across cases of payments to Directors, whereby, expenses of a personal nature were reimbursed.
b) The management of a limited company staffs that proposed dividend does not represent a liability and hence no provision needs to be made - Comment.
c) ABC Limited to whom CARO is applicable made a public issue of 7% debentures of Rs. 3

crores, redeemable after 5 years and used the proceeds of issue for payment of Sundry creditors and other Current liabilities to the tune of 3 crores. (May 2007)

Hint Ans:

a. All payments to Directors as remuneration or perquisites whether in the case of a public or private company are required to be authorized both in accordance with the Companies Act and Articles of Association of the company. Articles may provide that such remuneration require sanction of the shareholders either by ordinary or special resolution while in some cases it may require only approval of Directors. If the terms of appointment of a Director include payment of expenses of a personal nature, then such expenses can be incurred by the company; otherwise, no such expense can be incurred or reimbursed by the company. In the instant case the auditor has to ensure that the above is complied with, without which, if such expenses are paid, he has to disclose the fact in his report, as also in the accounts. In this regard attention is invited to section 227 (1A) (e) of the Companies Act wherein auditor has to inquire into whether personal expenses have been charged to revenue.

b. As per the **ICAI's Guidance Note**, proposed dividend does not represent a liability, nor does it amount to a provision, pending the approval of the share holders in the general meeting. Though the format given in **schedule VI** requires proposed dividend to be shown under 'Current Liabilities and Provisions', it does not mean in fact that the proposed dividend becomes a liability or is necessarily a provision. Part 1 of Schedule VI that prescribes the form of balance sheet requires "proposed dividend" to be shown under 'Provisions' and paragraph 3(xiv) of Part II of the same Schedule requires specific disclosure of the proposed dividend. It is recommended, that if no appropriation is made, shareholders' attention should be drawn to such fact and the amount should be quantified. The fact that provision for proposed dividend has not been made, should be disclosed by means of a note in the accounts. The auditor should refer to the note in his report and make his report subject thereto.

c. Refer Point No. 8.3-C-20

QUESTIONS

Q1. The Statutory auditors of Getwell Ltd. included certain comments in his report u/s 227 of the Companies Act, 1956. Since the company requested the auditors to drop the above comments, as otherwise it will affect their future business, as a compromise the auditor included the comment in the report in ordinary type. Comment (5 Marks) **(Nov 2008)**

Q2. PQR Ltd., a listed company and having an average annual turnover of more than Rs. 5 crores has no Internal Audit System. Give your views. (5 Marks) **(Nov 2010)**

Q3. a) OK Ltd. has taken a term loan from a nationalized bank in 2006 for Rs. 200 lakhs repayable in five equal installments of Rs. 40 lakhs from 31st March, 2007 onwards. It had repaid the loans due in 2007 & 2008, but defaulted in 2009, 2010 & 2011. As the auditor of OK Ltd. what is your responsibility assuming that company has sought reschedulement of loan? (4 Marks) **(May 2011)**

b) Big & Small Ltd. received a show cause notice from central excise department intending to levy a demand of Rs. 25 lakhs in December 2010. The company replied to above notice in January 2011 contending that it is not liable for the levy. No further action was initiated by the excise department up to the finalization of the audit for the year ended on 31st March, 2011. As the auditor of the company, what is your role in this? (4 Marks) **(May 2011)**

9. AUDIT COMMITTEE AND CORPORATE GOVERNANCE

9.1 Corporate Governance

i) Corporate governance is the **system** by which companies are directed and controlled by management in the best interest of shareholders and others.
ii) The **Board of Directors** is responsible for governance of their companies.
iii) SEBI also has introduced **clause 49 in the "Listing Agreement"** entered between a stock exchange and a company who desires to list its securities on stock exchange.
iv) As per this clause, if a company **desires to list** its securities on a stock exchange, then it has to agree and implement the code of corporate governance.
v) The company is also required to **obtain a certificate** from the auditor/ practicing company secretary as regard compliance of the conditions of corporate governance as given in this clause.

9.2 Contents Of Clause 49 Of Listing Agreement (Corporate Governance)

i) Board Of Directors - Composition

a. The Board of Directors shall have an optimum combination of executive and non-executive directors with **not less than fifty percent** of the Board of Directors comprising of **non-executive directors**.
b. At least half of the Board should comprise of **independent directors**. Overall shift is on comprising the Board with independent person, who can take unbiased decisions for the welfare of the stakeholders. '**Independent directors**' are those who apart from receiving their remuneration as directors have no other material pecuniary relationship or transaction with the company, its promoters, its management or its subsidiaries. The term executive and non-executive directors have not been explained.
Disclosure – The Company agrees that all pecuniary relationships or transactions of non – executive directors with the company should be disclosed in the annual report

ii) Audit Committee

a. Constitution:
• The committee shall have **minimum 3 members** (any director). **Two-third** of the members of the committee shall be **independent** directors.
• All members shall be **financially literate** & at least one director having expertise in accounts/financial management.
• **Chairman** should be an independent director.
b. Meeting - Minimum number of **meetings** in a year is **four**. One meeting should be held before finalization of Accounts. Maximum **gap** between 2 meetings is FOUR months.
c. Quorum - Quorum shall be of 2 members or 1/3 of members (whichever is higher) & out of which minimum 2 should be independent directors**.**
d. Company secretary of the company shall act as **secretary** of Audit committee.
e. Audit committee should **invite financial executive** of the company in its meeting. However, they can meet without his presence too.
f. Powers of Audit Committee – Illustrative and not exhaustive.
• To investigate any activity within its terms of reference.
• To seek information from any employee.
• To obtain outside legal or other professional advice.
• To secure attendance of outsiders with relevant expertise.

g. Role of Audit Committee:
• Oversight of the financial **reporting process** and the **disclosure** of its financial information to ensure that the financial statement is correct, sufficient and credible.
• Recommending the **appointment and removal** of external auditors, fixation of audit fee

and also approval for payment of any other services.
• Reviewing the **annual financial statements** before submission to the Board
• Reviewing the adequacy of **internal control system**.
• Reviewing the adequacy of **internal audit function**.
• Discussion with internal auditors any **significant findings** and follow-up thereon.
• Reviewing the findings of any **internal investigation** by the internal auditors.
• Discussion with external auditors before the audit commences **nature and scope of audit** as well as has post audit discussion to ascertain any area of concern.
• Reviewing the company's **financial and risk management policies**.
• To look into the **reasons for defaults** in the payment to the depositors, Debenture holders, shareholders (in case of non-payment of declared dividend) and creditors.
• Carrying out **any other function** as is mentioned in the terms of reference of the Audit Committee.

h. Functions of Audit Committee:

• 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 FS before submission to the Board and also ensure compliance of internal control systems.
• 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.

i. Audit committee shall review on mandatory basis:

• Management discussion & analysis of financial statements.
• Statement of significant related party transaction.
• Management letter / letters of internal control weaknesses issued by statutory auditors.
• Internal audit reports relating to internal control weaknesses.
• Appointment / Removal / Terms of remuneration of chief internal auditor.

iii) Remuneration Of Directors

a. All **pecuniary relationship or transactions** of the non-executive director with the company shall be **disclosed in the Annual Report**.
b. The **following disclosures** on the remuneration of directors shall be made in the section on the corporate governance of **the Annual Report**:
• All elements of **remuneration package** of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options, pension etc.
• Details of **fixed component and performance** linked incentives, along with the performance criteria.
• **Service contracts**, notice period, severance fees.
• **Stock option details**, if any – and whether issued at a discount as well as the period over which accrued and over which exercisable.
c. The company shall **publish its criteria of making payments** to non-executive directors in its annual report. Alternatively, this may be put up on the **company's website** and reference drawn thereto in the annual report.
d. The company shall **disclose the number of shares** and convertible instruments held by non-executive directors in the annual report.
e. Non-executive directors shall be required to disclose their **shareholding** (both own or held by / for other persons on a beneficial basis) **in the listed company** in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the **notice to the general meeting** called for appointment of such director.

iv) Board Procedure

a. The Company agrees that board meetings shall be held **at least four times** a year, with a maximum time gap of four months between two meetings.
b. The company agrees that a director shall **not be a member** in more than **10 committees** or act as a chairman of more than five committees across all companies in which he is a director.
c. Code of conduct for Board / senior management shall be laid by BOD. It shall be posted on the website of the Company.

v) Management - The Company agrees that the board shall provide a '**management discussion and analysis report'** as a part of annual report to the shareholders.
Content of Management Discussion and Analysis [Clause 49 IV (F)] - This Management Discussion & Analysis should include **discussion** on the **following matters** within the limits set by the company's competitive position:
a. Industry structure and developments.
b. Opportunities and Threats.
c. Segment—wise or product-wise performance.
d. Outlook
e. Risks and concerns.
f. Internal control systems and their adequacy.
g. Discussion on financial performance with respect to operational performance.
h. Material developments in Human Resources / Industrial Relations front, including number of people employed.
The management should make disclosure to the Board on all material financial and commercial transactions, where they have **personal interest** that may have a potential **conflict** with interests of the company as a whole.

vi) Shareholders

a. The company agrees that in case of **appointment of a new director** or re-appointment of an existing director the share holders shall be provided with following information: -
• A brief **resume** of the directors;
• Nature of his **expertise**; and
• **Name of companies** in which he holds directorship and membership of any committee of the board.
b. The company agrees that information like **quarterly results and presentation** made to analysts shall be put on **company's website or** shall be sent in such a form to the **stock exchange** where the shares are listed to put it on its own website.
c. The company further agrees that a board committee under the chairmanship of a non-executive director shall be formed to specifically look into redressing of shareholders and investors complaints like delay in transfer of shares, non receipt of annual report etc. The committee shall be designated as **'Shareholders / Investors' Grievance Committee'.**
d. The company agrees that to **expedite the process of share transfer** the board of the company shall **delegate the power** of share transfer to an officer or a committee or to registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once in a fortnight.

vii) CEO/CFO Certification Clause 49 V - CEO and CFO shall **certify to Board** that:
a. They have **reviewed financial statements** and the cash flow statement for the year and that to the best of their knowledge and belief:
• These statements **do not contain** any materially untrue statement or omit any material fact or contain statements that might be misleading;
• These statements together present a **true and fair view** of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations

b. There are, to the best of their knowledge and belief, **no transactions entered** which are fraudulent, illegal or violative of the company's code of conduct.
c. They **accept responsibility for establishing and maintaining internal controls** for financial reporting and that they have evaluated its effectiveness.
d. They have **indicated to the auditors** and the Audit committee
• Significant **changes in internal control** over financial reporting during the year;
• Significant **changes in accounting policies** during the year and that the same have been disclosed in the notes to the financial statements; and
• Instances of **significant fraud** of which they have become aware.

viii) Report On Corporate Governance
a. The Company agrees that the annual reports of the company shall include a **separate report** on corporate governance.
b. The report should **disclose noncompliance** of any mandatory requirements under listing agreements along with **reasons** therefore.

ix) Auditors' Certificate - The Company agrees to obtain a certificate from the auditors of the company regarding **compliance** of conditions of corporate governance and annexes the certificate to the director's annual report to the shareholders of the company.

9.3 Comparison Between Clause 49 And Sec 292A

Particulars	Clause 49 of the Listing Agreement	Section 292A of the Companies Act, 1956
Applicability of the Provision	**a)** Companies seeking listing for the first time; and **b)** All existing listed companies with a paid-up capital of ≥ Rs.3 Crores or net worth of ≥ Rs.25 crores at any time	Every public company having paid-up capital of not less than 5 crores shall constitute an audit committee (A.C.).
Composition of Audit Committee	Minimum 3 directors as members and 2/3rd of the members of A.C. shall be independent directors.	Minimum 3 directors of which 2/3 of the total no. of such directors shall be directors other than MD or WTD
Qualification of Members	All members shall be financially literate and at least one member shall have accounting or related financial management expertise.	No such reference is contained in the Companies Act, 1956.
Chairman	The Chairman shall be an "independent" director & shall be present at AGM to answer queries of the shareholders.	Members shall elect a chairman from amongst themselves. The Chairman shall attend the AGM to provide any clarification on Audit matters.
Invitees of the Audit committee	The Finance Director, head of internal audit & a representative of the statutory auditor may be present as invitees for the meetings of the A.C.	The Auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the A.C. but shall not have the right to vote.
Secretary to Committee	The Company Secretary shall act as Secretary to the A.C.	No such reference is contained in the Companies Act, 1956.

Requirements as per Sec. 292A, which are silent in clause 49 of Listing Agreement

Terms of Reference of BOD	No such reference is contained	A.C. shall act in accordance with terms of reference to be specified in writing by board.
Recommendation of A.C.	No such reference is contained	Recommendation on any matter relating to F.M., including audit report shall be binding on board
Recording the Reasons	No such reference is contained	If Board does not accept recommendation of A.C. it shall record the reasons thereof and communicate such reasons to shareholders.

9.4 Role Of Auditor In Audit Committee And Certification Of Compliance Of Conditions Of Corporate Governance

i) Role of Auditor

a. The auditor would be **informing** the audit committee on various matters connected with the audit from time to time.
b. He can contribute significantly in **assisting and advising** the audit committee as per the request of the audit committee, particularly in improving corporate governance, oversight of financial reporting process, implementation of accounting policies and practices, compliance with accounting standards, strengthening of the internal control systems in regard to financial reporting and reporting processes.
c. The auditor would be devoting substantial professional time in **assisting the management** and the audit committee to enable it to discharge its functions effectively and in certification of requirements of corporate governance.

ii) Certification of Compliance

a. The Auditor's responsibility in certifying compliance of requirements of corporate governance relate to **verification and certification of factual implementation** of requirements of corporate governance as stipulated in Clause 49 of the Listing Agreement.
b. In certification of compliance of requirements of corporate governance, the Auditor should comply with the "**Code of Ethics**" issued by the ICAI. The Auditor should conduct **verification of compliance** of requirements of corporate governance as stipulated in Clause 49 of the Listing Agreement in accordance with this Guidance Note.
c. The auditor should **document matters**, which are important in providing evidence to support the certificate of factual findings.
d. The auditor should consider obtaining **management representations** on conditions of Corporate Governance.

iii) A Performa of the Certificate to be issued by the Auditors regarding compliance of conditions of Corporate Governance is shown below:

CERTIFICATE

To,
The Members of.....
(Name of the entity)
We have examined the compliance of conditions of Corporate Governance by (name of the entity) for the year ended on ..... as stipulated in clause 49 of the listing Agreement of the said with stock Exchange(s).

The compliance of conditions of Corporate Governance is the responsibility of the management. Our examination was limited to procedures and implementation thereof, adopted by the company for ensuring the compliance of the conditions of the Corporate Governance. It is neither an audit nor an expression of opinion on the FS of the company.

In our opinion, and to the best of our information and according to the explanations given to us, subject to the following:
(1)
(2)
We certify that the company has complied with the conditions of Corporate Governance as stipulated in the above mentioned listing Agreement.
We state that no / ..... investor grievance(s) is / are pending for a period exceeding one month against the company as per the records maintained by the shareholders / investors Grievance Committee.
We further state that such compliance is neither an assurance as to the future viability of the company nor the efficiency or effectiveness with which the management has conducted the affairs of the company.

For & on behalf of
XYZ & Co.
CAs
(Partner / Proprietor)
Place.....
Date.....

CASE STUDIES

Q1. Design a Performa of auditor certificate as per Clause 49 of the listing agreement.
Hint Ans: **Refer** to Point No. 9.4 (iii)

Q2. Briefly discuss the additional requirements as per Section 292A, which are silent in clause 49 of the Listing Agreement.
Hint Ans: **Refer** to Relevant Part of Point No. 9.3

Q3. Explain the Constitution and functions of Audit Committee under Section 292A of the Companies Act, 1956.
Hint Ans: **Refer** to Point No. 9.2 (ii-a) & (ii-h)

QUESTIONS

Q1. State the main features of the Qualified and Independent Audit Committee set up under clause 49 of the listing agreement. (8 Marks) **(Nov 2008)**

10. AUDIT OF CONSOLIDATED FINANCIAL STATEMENTS (CFS)

10.1 Consolidated Financial Statement (CFS)

i) CFS is the financial statements **(FS) of a group** presented as those of a single entity. CFS is presented for a group of entities under the control of a parent. A 'parent' is an entity that has one or more subsidiaries. A group comprises a parent and its subsidiaries.
ii) AS 21 is applicable to a parent that presents CFS.
iii) CFS is presented, to the extent possible, in the **same format** as adopted by the **parent** for its separate financial statements.
iv) The **auditor of the CFS** may **not necessarily** be the auditor of the separate FS of the parent or one or more of the components included in the CFS Responsibility of Parent responsibility for the preparation and presentation of CFS, among other things, is that of the management of the parent.

10.2 Responsibility Of Parent - The responsibility for the preparation and presentation of CFS, among other things, is that of the management of the parent. This includes:
i) identifying components, and including the financial information of the components to be included in the CFS;
ii) where appropriate, identifying **reportable segments** for segmental reporting;
iii) identifying **related parties** and related party transactions for reporting;
iv) obtaining accurate and **complete financial information** from components; and
v) making appropriate consolidation **adjustments.**

10.3 Responsibility Of The Auditor Of The CFS - The auditor of the CFS is responsible for expressing an opinion on whether the CFS are prepared, in all material respects, in accordance with the financial **reporting framework** under which the parent prepares the CFS. Therefore, the **auditor's objectives** in an audit of CFS are:
i) to satisfy himself that the CFS have been prepared in accordance with the requirements of "AS 21 – CFS", "AS 23 - Accounting for Investments in Associates in CFS" and "AS 27 - Financial Reporting of Interests in Joint Ventures"
ii) to enable himself to express an opinion on the true and fair view presented by the CFS.

10.4 Audit Considerations –
i) The auditor of the CFS has to **use the work of other auditors** unless the auditor of CFS is not the auditor of the other components of the group.
ii) The CFS are prepared **using the separate FS** of the parent, subsidiaries, associates and joint ventures and also other financial information, which 'might not be covered by the separate FS of these entities. the 'other financial information' would include disclosures to be made in the CFS about the subsidiaries associates and joint ventures, proportion of items included in the CFS to which different accounting policies have been applied etc.
iii) Where the statutory **auditors of** one or more of the **components** of the CFS are also requested to **assist the principal auditor**, the work to be performed by such statutory auditors for use by the principal auditor would constitute an assignment separate from the assignment to conduct the statutory auditor the respective component.
iv) The principal auditor, if he decides to use the **work of another auditor** in relation to the audit of CFS, should comply with the requirements of **SA 600**.

10.5 Auditing The Consolidation –
i) The auditor should make **plans,** among other things, for the following:
a. understanding of **accounting policies** of the parent, subsidiaries, associates and joint ventures. **b.** determining the extent of **use of other auditors** work in the audit.

c. determining and programming the nature, timing, and extent of the **audit procedures** to be performed; **d. Co-coordinating** the work to be performed.
ii) The auditor should obtain a **listing of subsidiaries**, **associates and JV**
iii) The auditor should verify that all the subsidiary. Associates & JV have been included in the CFS unless a subsidiary, associate or JV meets a **criterion for exclusion**.
iv) There could be **two reasons** for exclusion of a subsidiary, associate or jointly controlled entity (JCE) that the relationship of parent with the subsidiary, associate or JCE is intended to be temporary or subsidiary, associate or JV operates under several long-term restrictions which significantly impair its ability to transfer funds to the parent. Auditor should satisfy himself that exclusion made by management falls within these two categories.
v) The auditor should verify that the **adjustments** warranted by the relevant accounting standards have been made wherever required and have been properly **authorized** by the management of the parent the preparation of CFS gives rise to permanent consolidation adjustments and current period consolidation adjustments.

10.6 Special Considerations
i) Permanent Consolidation Adjustments – Permanent consolidation adjustments are those adjustments that are made **only on the first occasion** of the preparation and presentation of CFS. Permanent consolidation adjustments are:
a. determination of **goodwill or capital reserve;**
b. determination of the amount of **equity** attributable to **minorities**: and
c. determination of goodwill or capital reserve arising on application of equity method to account for **investments in associates in CFS**.
d. The auditor should verify that the above **calculations** have been made appropriately.
e. The auditor should pay particular attention to the determination of **pre-acquisition reserves** of the subsidiary and associates
ii) Current Period Consolidation Adjustments –
a. Current period adjustments are those adjustments that are made in **the accounting period** in which the consolidation of financial statements is done. Current period consolidation adjustments **primarily relate to** elimination & intra-group transactions and account balances including: • intra-group interest paid and received, or management fees, etc; • Unrealized intra group profits on assets acquired from other subsidiaries; • intra group indebtedness etc.
b. The auditor should gain an understanding of the **procedures adopted** by the management of the enterprise to make the above mentioned adjustments. This helps the auditor in reducing the audit risk to an acceptably low level.
c. The auditor of the CFS should obtain evidence that the management of the parent acknowledges its responsibility for a true and fair presentation of the CFS

10.7 Management Representations - The auditor of the CFS should obtain evidence that the management of the parent acknowledges its responsibility for true and fair presentation of the CFS in accordance with the financial reporting framework applicable to the parent and that parent management has approved the CFS. In addition, the auditor of the CFS obtains written representations from parent management on matters material to the CFS.
i) Completeness of components included in the CFS;
ii) Identification of **reportable segments** for segmental reporting;
iii) Identification of **related parties** and related party transactions for reporting;
iv) Appropriateness and completeness of **consolidation adjustments**, including the elimination of intra-group transactions.

10.8 Reporting -

i) When the Parent's Auditor is also the Auditor of its Subsidiaries - Auditor should report whether **principles & procedures** for preparation and presentation of CFS as laid down in the relevant AS have been followed. In case of any **deviation**, the auditor should make adequate disclosure in the audit report.

ii) When the Parent's Auditor is not the Auditor-of its Subsidiary

a. In a case where the parent's auditor is not the auditor of the components included in the CFS, the auditor of the CFS should also consider requirement of **SA 600**.

b. Reference in the report of the auditor of CFS to the fact that part of the audit & the group was made by other auditor(s) is an-indication of the divided response between the auditors of the parent and its subsidiaries.

CASE STUDIES

Q1. What are the Responsibilities of the Auditor of the Consolidated FS?
Hint Ans: Refer Point No. 10.3

Q2. "Permanent Consolidation Adjustments are made only on the first occasion of the preparation and presentation of consolidated FS". Explain the role of auditor in the context of Permanent Consolidation Adjustments.
Hint Ans: Refer Point No. 10.6 - i

Q3. While doing the audit of CFS, which current period consolidation adjustments are to be taken into account?
Hint Ans: Refer Point No. 10.6 - ii

11. AUDITS OF BANKS

11.1 Principal Enactments Governing Bank Audit

The principal enactments which govern the functioning of various types of banks are:
i) Banking Regulation Act, 1949
ii) StateBankofIndiaAct,1955
iii) Companies Act, 1956
iv) State Bank of India (Subsidiary Banks) Act, 1959
v) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970
vi) Regional Rural Banks Act, 1976
vii) Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980
viii) Information Technology Act, 2000
ix) Prevention of Money Laundering Act, 2002
x) SARFAESI Act, 2002
xi) Credit Information Companies Regulation Act, 2005
xii) Payment and Settlement Systems Act, 2007
Besides, the above enactments, the provisions of the RBI Act, 1934, also affect the functioning of banks. The Act gives wide powers to the RBI to give directions to banks which also have considerable effect on the functioning of banks.

11.2 Special Features of Banks

i) Custody of **Large Volume** of Monetary Item.
ii) Large Volume and **Variety** of Transactions.
iii) Wide Network of Branches and Departments.
iv) Off-Balance Sheet items (no entry like guarantees etc.)
v) Regulated by Government authorities.

11.3 Books And Accounts - A banking company is required to maintain the books of account in accordance with section 209 of the companies act, 1956. The main **characteristic of a bank's system** of book keeping are as follows.
i) Entries in personal ledger made **directly** from the vouchers instead of being posted from books of prime entry.
ii) The **vouchers** entered into different personal ledgers each day are summarized on a **summary sheet** and the totals of which are posted to control account in general ledger.
iii) The **general ledger trial balance** is extracted and agreed every day.
iv) All entries in the personal ledger and summary sheet are **checked** by persons other than those who have made the entries.
v) A **trial balance of detailed personal ledger** is prepared **periodically** and agreed with general ledger control account.
vi) Except for cash transactions, always **two vouchers** are prepared for each transaction, one for debit and other for credit.

Principal Books of Account: The following are the principal books of account maintained.
i) General ledger
ii) Profit and loss ledger
iii) Personal ledger divided as current accounts, savings accounts, other deposit accounts, loan accounts etc.
iv) Bills register divided as bills purchased, inward bills for collection, outward bills for collection etc.
v) Other subsidiary ledgers
vi) Departmental journal to note transfer entries passed by it.
vii) Memoranda books like receiving cashier's cash book, paying cashier's cash book, clearing book etc.

11.4 Form and Content of Financial Statements - Sub-section (1) of sec. 29 requires every banking company to prepare a B/S and a P/L account in the forms set out in the Third Schedule to the Act or as near thereto as the circumstances admit.

i) Form A Of The Third Schedule To The Banking Regulation Act, 1949, Contains The Form Of Balance Sheet.

a. Capital and Liabilities (5 heads)
• Capital • Reserve and Surplus • Deposits • Borrowings • Other liabilities and provision
b. Assets (6 heads)
• Cash and Balance with R131 • Balance with Banks and money at call and short notice.
• Investment • Advances • Fixed Assets • Other assets
c. Contingent Liabilities and Bills for collection (aggregate amount to be shown on face of Balance sheet and details by way of a note).

ii) Form B Contains The Form Of Profit And Loss Account

a. Income - • Interest Earned • Other Income
b. Expenditure - • Interest expended • Operating expenses • Provision and Contingencies
c. Profit / Loss - • Net profit (loss) for the year • Profit / Loss brought forward
d. Appropriations - • Transfer to Statutory Reserve • Transfer to other Reserves • Transfer to Government / Proposed Dividend • Balance carried over to B/S.

iii) Other Disclosures - In addition to the disclosures to be made in the balance sheet and profit and loss account in pursuance of the requirements of the Third Schedule to the Act, the RBI has directed to disclose some other information specified by RBI by way of notes on accounts. This information has been given in Annexure II to this chapter.

iv) Notes and Instructions Issued by Reserve Bank of India - The RBI has issued notes & instructions for compilation of B/S and P/L A/C. These notes and instructions provide an authoritative interpretation of the requirements of Third Schedule to the Act and are thus useful in preparation of FS of banks. Notes & instructions are reproduced as Annexure II.

v) Requirements of Banking Regulation Act, 1949, vis a vis Companies Act, 1956 – The requirements of the Companies Act, 1956, relating to the B/S and P/L A/C of a company, in so far as they are not inconsistent with the Banking Regulation Act, 1949, also apply to the B/S or P/L A/C, as the case may be, of a banking company.

vi) Signature - FS of a banking company incorporated in India to be signed by manager / principal officer and by at least 3 directors that of foreign Banking Company to be signed by Manager / Agent of the Principal Office in India.

11.5 Audit of Accounts

i) Appointment of Auditor

a. Auditor of Banking Company to be appointed at **AGM of shareholders** wherein fee is also determined. Prior approval of RBI is required. Auditor of nationalized Bank is appointed by **BOD**. Prior approval of RBI is required. Fee is determined by RBI in consultation with CG.
b. Auditor of **subsidiaries of SBI** as well as their remuneration is decided by SBI.
c. Auditor of **SBI** and their remuneration by RBI in consultation with Government.
d. RRB's auditors and their fee determined by Bank concerned with approval of CG.

ii) Auditor's Report

a. For Nationalized Bank - Report to CG stating:
- Whether Balance Sheet is full and properly drawn up and True and Fair View.
- Whether Transactions of Banks are within their powers.
- Whether Returns received from offices and branches of Banks are adequate.
- Whether P & L account shows true balance of profit or loss.

b. For Banking Companies - In addition to reporting u/s 227, also to state whether -
- Information and Explanations are satisfactory.
- Transactions of company are within power of company.
- Returns received from branches are adequate.
- P&L show true balance of profit or loss.
- Any other matter to be brought to notice of the share holders of the company.

c. Long Form Audit Report (LFAR) - Besides the audit report as per the statutory requirements discussed above, the terms of appointment of auditors of public sector banks, private sector banks and foreign banks as well as their branches, require the auditors to also furnish a LFAR. The **matters** which the banks require their auditors to deal with in the long form audit report have been **specified by the RBI**.

11.6 Conducting A Bank Audit - The stages of audit of a bank are:

i) Initial consideration by the Statutory Auditor
ii) Identifying and Assessing the Risks of Material Misstatements
iii) Understanding the Bank and Its Environment including Internal Control
iv) Understand the Bank's Accounting Process
v) Understanding the Risk Management Process
vi) Engagement Team Discussions
vii) Establish the Overall Audit Strategy
viii) Develop the Audit Plan
ix) Audit Planning Memorandum
x) Determine Audit Materiality
xi) Consider Going Concern
xii) Assess the Risk of Fraud including Money Laundering
xiii) Assess Specific Risks
xiv) Risk Associated with Outsourcing of Activities
xv) Response to the Assessed Risks
xvi) Stress Testing
xvii) BASEL II framework.

11.7 Internal Controls

i) General Controls

a. The **staff and officers** of the bank should be shifted from one position to another frequently and without prior notice.
b. The work of one person should be **checked** by another person.
c. A responsible officer should be given **possession of demand drafts**, cheque books etc.
d. The **signature book** & telegraphic code book should be kept with a responsible officer.
e. The bank should take **insurance policies** against loss and employee's infidelity.
f. The **management structure** should be clearly drawn and rights and duties should be properly understood.

ii) Cash

a. Cash should be kept in **joint custody** of at least two responsible officers.
b. Surprise checking should be conducted.
c. The **cashier** should **not have access** to customer's ledger accounts and the day book.
d. Payments should be made only after the **vouchers** are **passed** by a proper officer.

e. Receipt and payment **scrolls** (**memoranda books** maintained by the cashier) should be compared with the cash column of the day back by an independent person.
f. The limits on the **payment powers** of the teller should be laid out.

iii) Constituent's Ledger
a. Before making payment, cheques should be **checked** in respect of signature, date, balance on hand and should be passed by a proper officer.
b. No withdrawals should normally be allowed against clearing cheques deposited on the same day.
c. Ledger keepers should **not** have **access** to voucher **summary sheets**.
d. Interest debited or credited to constituents' account should be independently checked.

iv) Bills for Collection
a. All **documents** accompanying the bill should be received and entered in the register by a proper officer.
b. The **accounts** of the principals should be credited only after realization of the bill.
c. It should be ensured that bills sent by one branch to **another branch** for collection are not included twice in the amalgamated balance sheet.

v) Bills Purchased
a. At the time of purchase of the bills, an officer should verify that all **documents of title** are properly assigned to the bank.
b. Sufficient margin should be kept while purchasing or discounting of a bill.
c. All irregular **outstanding accounts** should be periodically reported to the head office.
d. In case of purchase or discounting of a bill, **proportionate income** should be recognized between the periods.

vi) Loans and Advances
a. The bank should make advances only after critical assessment of borrower's **credit worthiness.**
b. All necessary **documents** should be duly executed by parties before advancing of loan.
c. Sufficient **margin** should be kept against security offered.
d. Securities requiring registration should be **registered** in banks name.
e. Surprise inspection of hypothecated goods should be conducted.
f. Market value of the security should be checked by the officers of the bank and the same should be entered in the drawing power book.
g. All the accounts which exceed the **sanctioned limit** or are against unapproved securities should be brought to the notice of the head office.
h. Periodical review of operation of the account is important.

vii) Telegraphic Transfers and Demand Drafts
a. The bank should have a reliable **private code** known only to responsible officers.
b. The signature on the **demand draft** should be checked with the signature book.
c. All the **telegraphic transfers** and demand drafts sold by a branch should be immediately confirmed by the advices to the branch concerned.
d. If the paying branch does **not receive proper confirmation** of any telegraphic transfer or demand draft or does not receive credit from the issuing branch, it should take immediate steps to ascertain the reasons.

viii) Credit Card Operations
a. There should be effective **screening** of applications with reasonably good credit assessment.
b. There should be **strict control** over storage and issue of credit cards.

c. The system whereby the merchant confirms the **unutilized balance** of the customer with the bank before accepting payment should be properly installed.
d. There should be a system of prompt reporting by the merchants of all **settlements** accepted by them through credit cards.
e. All the **reimbursements** should be immediately charged to the customer's account.
f. Items **overdue** beyond a reasonable period should be identified & attended to carefully.
g. There should be a system of **periodic review** of credit card holder's accounts.

11.8 Verification And Valuation Of Assets And Liabilities

i) Cash; Bank Balances and Money at Call and Short Notice –

a. Cash

• The auditor should count the **balance** of cash on hand.
• **Physical verification** of cash at branch offices should also be conducted at or near the year end.
• There should **not be any cash movement** till the counting is completed.
• Verify physical balance with the **denomination book**.
• **Foreign currency notes** should be verified by actual inspection and should be converted at market rate prevailing on the closing day.

b. Balance with Reserve Bank of India

• Verify ledger balance with **confirmation certificate** from RBI.
• Review the **reconciliation statement**.
• **Special attention** should be given to: Cash transactions remaining un-responded, Revenue items requiring adjustment, Old outstanding balances remaining un-responded for over one year.

c. Balances with Bank (other than Reserve Bank of India) - Apart from procedures described above special attention should be given to:
• **Large transactions** towards the **end of the year** to check any window dressing.
• Examination of old **unadjusted transactions**.

d. Money at Call and Short Notice – The Auditor should check:
• Proper **system of authorization** available for lending money at call and short notice.
• **Certificate** of the borrowers and the call loans receipts held by the bank.
• Whether **balances** as per call loan register agrees with Control A/c in general ledger.
• **Call loans** made by bank should not be **netted off** against call loans received.

Cash Reserve - One of the important determinants of cash balances to be maintained by banking companies and other scheduled banks is the requirement for maintenance of a **certain minimum cash reserve**. While the requirement for maintenance of cash reserve by banking companies is contained in the Banking Regulation Act, 1949, corresponding requirement for scheduled banks is contained in the Reserve Bank of India Act, 1934.

Statutory Liquidity Ratio - Section 24 of the Banking Regulation Act, 1949 requires that every banking company shall maintain in India in cash, gold or unencumbered approved securities an amount of which shall not, at the close of business on any day, be less than **such percentage** not exceeding forty, as the RBI may from time to time specify, of the **total of its demand and time liabilities in India** as on the last Friday of the second preceding fortnight. This is referred to as 'statutory liquidity ratio'.

ii) Investments -

a. Investments in India in - • Government securities • Other approved securities • Shares • Debentures and Bonds • Subsidiaries and/or joint ventures • Others

b. Investments outside India in - • Government securities (including local authorities) • Subsidiaries and/or joint ventures abroad • Other investments (to be specified)

The Following Are Some Of The Terms Which Are Commonly Used In Relation To Investments Of Banks:

a. Approved Securities - Section 5(a) of the Banking Regulation Act, 1949 defines 'approved securities' to mean securities in which a trustee may invest money under clauses (a) to (d) and (f) of section 20 of the Indian Trusts Act, 1882. Approved securities comprise primarily the securities issued or guaranteed by the **CG or SG,** or any other security expressly authorized by the CG by notification in the official gazette.

b. Bank Receipt (BR) - Bank receipt is **acknowledgement from the selling bank** to the buying bank that the former has received payment for certain securities, which it will deliver within a certain time. BR is non-transferable and can be issued by banks and certain specified institutions only.

c. Collateralized Borrowing and Lending Obligation - CBLO is a **discounted instrument** available in **electronic book** entry form for the maturity period ranging from one day to ninety days (can be made available up to one year as per RBI guidelines).

d. Government Security - A government security is an instrument **issued** by the CG or SG, which is redeemable after a fixed period and may either, is coupon bearing or issued at discount to face value.

e. Liquidity Adjustment Facility (LAF) - A **monetary tool** used by the RBI for injecting liquidity or absorption of the liquidity from the banking system. The LAF is operationalised through Repo and Reverse Repo.

f. Negotiated Dealing System (NDS) - It is an electronic platform for **facilitating dealing** in Government Securities and Money Market Instruments. It is **closed user** group network **open only** for its members.

g. NDS OM - Negotiated Dealing System (RBI-NDS-GILTS-Order Matching Segment), NDS-OM for short, is an electronic order matching **trading module for Government securities** on its Negotiated Dealing System.

h. Portfolio Management Scheme (PMS) - In a portfolio management scheme, the bank administering the scheme makes **investments on behalf** of clients for a 'management fee'. This is a fiduciary activity in which the profit or loss from the transactions belongs to the client.

i. Prudential Exposure Limits - The RBI from time to time **prescribes the limits** up to which investments in any one type of security or in any industry group or in any one company/group of companies, etc, can be made by a bank. These limits are known as "Prudential Exposure Limits".

j. Ready-forward Transactions or Repo - Ready-forward or Repo transactions are **arrangements** for current sale of securities and their simultaneous **re-purchase at a future date at a price fixed** at the time of sale. From the viewpoint of the other party, the transaction involves current purchase and subsequent resale of the securities concerned.

k. Repo Constituents' SGL Account (RC SGL Account) - A SGL account of a bank maintained with RBI with authorization to RBI to act as **custodian on its behalf**, where the

securities delivered by RBI under Repo is **held.**

l. Reverse Ready-forward Transactions or Reverse Repo - Reverse Ready-forward or Reverse Repo transactions are arrangements for **current purchase** of securities and their **simultaneous re-sale** at a future date at a price fixed at the time of purchase.

m. Reverse Repo Constituents' SGL Account (RRC SGL Account) - A SGL account of a bank **maintained with RBI** with authorization to RBI to act as **custodian** on its behalf, where the securities to be delivered to RBI under Reverse Repo is **held**.

n. Subsidiary General Ledger (SGL) - This is a ledger maintained by the Public Debt Office (PDO) of RBI in which accounts of different banks are maintained regarding their **holding** of select government securities. On a purchase or a sale of the securities, the transaction is **recorded** when the purchasing bank sends to PDO the Subsidiary General Ledger Form (SGL Form), **signed on behalf** of both the transferor and the transferee banks. In case the transaction is transacted at NDS, the CCIL, as central counter party, issues instructions to debiting/crediting of the SGL accounts with PDO. **PDO acts like a depository** in respect of government securities.

o. Treasury Bills - Treasury bills are government securities representing obligations, which **mature in one year or less** and are **issued at a discount** to the face value.

p. Yield-to-Maturity (YTM) - This is the average annual compound rate of return on a security (taking into account both the interest and the redemption value), which the investor will earn **if he holds** it **till maturity**. YTM rates are put out by the PDAI/FIMMDA at periodical intervals.

Audit Procedures

a. Internal Control Evaluation and Review of Investment Policy - The auditors should familiarize themselves with the **instructions issued by the RBI** regarding transactions in securities. They should **review the investment policy** of the bank to ascertain that the policy conforms, in all material respects, to the **RBI's guidelines** as well as to any **statutory provisions** applicable to the bank.

b. Separation of Investment Functions -The auditor should also examine whether the bank, as required by the RBI, is maintaining **separate accounts** for the investments made by it on their own Investment Account, on PMS clients' account, and on behalf of other constituents (including brokers).

c. Examination of Reconciliation -The auditor should examine the reconciliation of the **investment account**, **physically verify** the securities on hand, **obtain confirmations** from counter-party banks for BRs issued by such banks and on hand, obtain confirmation of SGL balances with the PDO, and examine the control and reconciliation of BRs issued by the bank.

d. Examination of Authority - The auditor should ascertain whether the investments made by the bank are within its **authority.** In this regard, the auditor should examine whether the legal requirements governing the bank, in so far as they relate to investments, have been complied with and the investments made by the bank are **not ultra vires** the bank.

e. Physical Verification - The auditor should verify the **investment scrips** physically at the close of business on the date of the balance sheet. Investments are normally dealt with

at the **head office** and not at the branches. However, sometimes, for realization of interest etc., and other similar purposes, some of the investment scrips may be held at branch offices. In such cases, the auditor should examine the **records** maintained at the head office to record details of scrips held at other locations and request the respective branch auditors to physically verify such scrips as a part of their audit. The auditor should obtain a **written confirmation** to this effect from the branch auditors.
In case the investment scrips are held at an **unaudited branch**, the auditor should request the management to obtain the scrips at the head office for his examination.
In respect of scrip less dealings in investments through the **OTC Exchange of India**, the auditor should verify the interim and other acknowledgements issued by dealers as well as the year-end confirmation certificates of the depository organization.

f. Examination of Valuation - Investments in securities now-a-days constitute a **substantial part** of total assets of many banks. The auditor should examine whether the **method** of accounting followed by the bank in respect of investments, including their year-end valuation, is appropriate.

g. Dealings in Securities on Behalf of Others - Apart from making investments on its account, a bank may also **deal in securities** on behalf of its customers only with the **prior approval from RBI**. These activities of banks are in the nature of trust or fiduciary activities.

h. Examination of classification and shifting - The auditor should examine whether the shifting of the investments from available for sale to hold to maturity is duly **approved by the BOD** of the bank. The auditor should also ensure the **compliance of the RBI guidelines**, issued from time to time, in this regard.

Classification Of Investments - The classification should be **determined at the time of acquisition** of such securities, and the decision should be **recorded** on the **investment proposal**.

i) Basics

- Banks should frame suitable Investment policy.
- Classification of Investment: **a.** Held to maturity **b.** Available for Sale **c.** Held for Trading
- Disclosure in account is same as present 6 categories.

a) Held To Maturity (HTM)

- Intention Basis.
- **HTM < 25**% of Banks total Investment.
- Following not to be Covered /Counted for 25%
  - → Re-capitalization Bonds from govt. of India.
  - → Investment in subsidiary & Joint Venture.
  - → Investment in Debenture/Bonds if deemed to be in nature of advance i.e.
    - If issued for project finance (3 Yrs. or more)
      Or
      If issued for working capital finance (less than 1 yr.)
      and
    - Banks stake is 10% in issue.
      and
    - Issue is part of private placement.
- Profit on sale of such Investment is to be taken to P&L account & thereafter to Capital Reserve account. Loss to P&L account.
- Carried at acquisition cost. If acquisition Cost is more than face value there amortise the premium. Recognize permanent diminution.

b) Held For Trading

• Intention to trade for short term price/Interest rate gain
• To be sold within 90 Days
• Profit or loss on sale to P&L account
• Marked to Market at Monthly/Frequent intervals.

c) Available For Sale

• If not in above 2 categories.
• Profit or Loss on sale to P/L A/c.
• Valuation → individually script-wise Marked to Market at quarterly/frequent interval.
• Fall in value to be provided (appreciation ignored for this purpose) Debit to P&L A/c & equivalent amount to be transferred from Investment Fluctuation Reserve account to P&L account.

Investment Fluctuation Reserve (IFR)

• Banks are required to create IFR at **minimum 5%** of investment within **5** years (only w.r.t. held for trading and available for sale) and Maximum **up to 10%** of Portfolio (only w.r.t held for trading and available for sale)
• Transfer maximum amount of gains realised on sale of Investment in Securities to Investment Fluctuation Reserve (IFR)
• IFR is eligible for inclusion in Tier-2 Capital.
• Transfer to IFR as appropriation to net Profit "below line" after statutory Reserve.

Shifting Among Categories of I

• To/from HTM → Approval of BOD. Shifting can take place once a year at beginning of year.
• From AFS to HFT → with approval of BOD / ALCO/ Investment Committee.
• From HFT to AFS → Generally not allowed only in **exceptional** situation with permission of BOD / ALCO (asset liability committee) / Investment Committee.
• Transfer at least of acquisition Cost/ Book value/ Market value on date of Transfer.

Income Recognition on I

• Accrual Basis on securities, if guaranteed by Central govt.
• Otherwise, if owner's right is established.
• From mutual funds, on cash Basis.

Broken period Interest - Banks not to capitalize BPI paid to seller as part of cost but treat as expenses in P&L account.

iii) Loans and Advances

No banking company can make any loans or advances on the security of its own shares. It also **cannot grant** loans and advances to or on behalf of:
• Any of its directors • Firm in which any of its directors are interested as a partner, manager, employee or guarantor. • Any company in which any of its directors is a director, manager, employee, guarantor or holds substantial interest. • Any individual in respect of whom the director is a partner, guarantor or employee.

Audit of Advances - In carrying out audit of advances, the auditor is primarily concerned with satisfying himself that:
• All advances have been **correctly recorded** in the books. • The basis of **Valuation** of advances and securities is appropriate and applied uniformly and consistently. • The **disclosure** requirements and **guidelines** laid down by the RBI have been complied with.

Evaluation of Internal Control System - Evaluation of the internal control system over advances helps the auditor in determining the nature timing and extent of substantive procedures. Internal Control over advances includes the following:
• All Advances are made after proper assessment of the **creditworthiness** of the applicant.
• All advances are properly **authorized.**
• All necessary **documents** (e.g. agreements, demand promissory notes, letter of security etc.) should have been executed and properly filed. Along with these documents, the auditor should also examine the following documents.

a. In case of a company, the certificate of incorporation, MOA & AOA
b. In case of a partnership firm, the partnership deed.
c. The letter of intent to provide security against advance advances, documents evidencing ownership of security by the borrower/guarantor and documents creating charge on such assets in favour of the bank.
• The auditor should also examine the sufficiency of **margin** of securities provided to the bank.

Verification of Advances - Advances normally form the **largest item** on the assets side of the balance sheet of a bank and is a major source of income to the bank. Therefore, verification of advance is an important function of an auditor of a bank. The auditor should be well equipped regarding documentation, valuation and provisioning of advances. He should look into the following points while undertaking verification of advances for banks.
a. Checking of Advances - The auditor shall review the **following** about all major advances • Quarterly information submitted by borrowers. • Periodic securities statements. • Financial statements of borrowers. • Reports of inspection of stocks • Auditors report in case of borrowers enjoying credit limits of Rs.10 lacs and above for working capital form the banking system.
b. Priority Sector Advances - While examining these advances, the auditor may carry out a **test check of each category** (substandard, doubtful etc) as mentioned in point (vi) in respect of each type of such advance. He should also examine whether appropriate steps have been taken for lodging of claims for guarantees in accordance with the applicable procedure.
c. Consortium Advances - The auditor should examine • Compliance with the limits stipulated by the consortium in lending money to borrowers. • Follow-up with lead banks on pending issue.
d. Checking of Statements and Sanctions - Statements of cash credits, over-drafts, packing credit furnished by the bank should be verified not only with the statements and supporting records but also with sanctioned terms and conditions.
e. Scrutiny of Customers Accounts - Check the balances as shown in the schedule of loans and advances with the ledger accounts. In the event of certain adverse features like over-drawn account, nonpayment of the installments etc., auditor should scrutinize the account with the extreme care. The auditor should particularly look into those accounts where balance at the yearend is brought down by showing repayments and fresh advances are granted immediately in the next year.
f. Classification of Advances and Provisioning for Bad & Doubtful debts - The auditor is also required to satisfy himself regarding the adequacy of provisions made for the different categories of advances as per RBI guidelines discussed in 11.11.
g. Interest Calculations - The auditor should satisfy himself that interest is being charge on all **performing accounts regularly**. He should compare the **rate** of interest with the agreement and the sanction. Calculation of interest should be test checked.
h. Verification of Securities - Shares, quantity of goods hypothecated, weight of ornaments and bullion, assignment of Life Insurance Policy, Fixed Deposit receipts, mortgage deeds and other documents etc held as Security should be **verified physically**. Where the security is not in the effective **possession** of the bank the auditor should verify whether the bank had adequate **legal documents** to take effective possession. The **Valuation** for each of the above should be checked from **market quotations**, invoices, surrender value, architect's certificates etc as is applicable to see whether it is adequate to cover the advances.
i. Inspection of Godowns - Check Balances in **Stock reports** with the balance in Godown Registers in the case of pledge accounts. Test check **valuation** of goods report old slow moving and non-moving stocks. Ensure pledged goods are under lock and key of the bank and also see that goods are properly insured against theft fire, riot, strike etc.

j. Disclosure Requirements - The auditor should also ensure that advances are classified in the balance sheet in accordance with the Third Schedule to the Banking Regulation Act 1949.

k. Certain Important Areas - Some Common Points for Verification of Loans Are

• Loan documents to be checked. • Check the securities hypothecated against loan. • Check the internal control, procedures for loans applied by the bank. • Whether loan agreements (sanction limits) are within authority of bank. • Whether bank is properly following up the loan. • Check NPA and their provisions. • Interest calculations should be examined. • Whether there is healthy turnover in account. • Whether repayment schedule is made considering repayment capacity of borrower. • If borrower is a company, whether there is proper resolution to borrow amount from bank.

1. Additional Points W.R.T. Loan To Dot Com Company - • Examine the feasibility of revenue model submitted by the Dot Com Company to the bank. He may obtain Expert's advice as well. • Ensure that there is appropriate capital base in the company i.e. it is not solely dependent on outside sources only.

2. Additional points w.r.t. Loan against Life Insurance Policies - • Security value is considered as surrender value of policy • Whether Premium is deposited on time • At maturity of policy, cheek procedures to be applied by the bank • Policy documents to be checked.

3. Additional points w.r.t. Loan against Stock Exchange securities - • physically check confirmation from Depository Participant. • Market values of securities to be checked • Advance would be against fully paid shares • Advance against shares which are on lending list of bank.

4. Additional points w.r.t. Loan Against pledge /hypothecation of goods - • Margin should be maintained. • Goods should be in original packing / periodic surprise visits • physically check / stock statements • Godowns & stock adequately insured • Basis of valuation of goods • Slow moving or fast moving goods. Check banks policy for advances against the same.

iv) Fixed Assets - The fixed assets have to be classified into **two categories** viz, premises and other fixed assets. In carrying out an audit of fixed assets, an auditor is primarily concerned about their existence and valuation. The audit procedure generally comprises of following activities:

• The auditor should satisfy himself about the **authorization procedures**, control system and documentation with regards to construction, acquisition, and disposal of fixed assets.
• In case of leasehold premises, capitalization and amortization of lease premium, if any, should be examined.
• In case the **title deeds** are held at head office or some other location, the auditor should obtain written representation from branch management and should bring this fact to the notice of central auditor.
• The auditor should examine the **classification of expenditure** on computer software. The software essential for the functioning of the hardware should be classified as part of related hardware. Application software should be treated as intangible asset.

v) Other Assets - The following assets are disclosed under this head:

• Inter Office Adjustments (Net). • Interest Accrued. • Tax Paid In Advance / Tax Deducted At Source. • Stationery and Stamps. • Non Banking Assets Acquired In Satisfaction of Claims. • Others.

The Audit Procedure With Regard To Other Assets Is Considered Below:

Inter Office (Inter Branch) Adjustments: The main transactions between offices of a bank include bills sent by one branch to another for collection, demand drafts, travelers cheques, remittance of cash for one branch to another, etc. The procedure for verification is

as follows:
• See that all the **inter office accounts** are periodically reconciled.
• Examine that the **adjustments** in respect of all amounts are reasonable and supported by adequate documentary evidence as to their validity.
• Ensure that **reversal entries** are made under proper authority and after due explanation and evidence.
• Enquire into items that remain **unadjusted** for a very long time.

vi) Capital - Any **increase** in the authorized capital can be verified from the shareholders resolution and memorandum of association. An **increase** in subscribed and paid-up capital should be verified with reference to prospectus, reports from registrars to the issue, bank statement, etc.

vii) Reserves and Surplus - The auditor should verify the **opening balance** of various reserves with reference to the audited balance sheet of previous year. Any increase or decrease should be verified with reference to **board resolution**. In case of the statutory reserve and share premium, compliance with **legal requirements** should be also verified.

viii) Deposits - The auditor should verify various types of deposits in the following manner:
a. Current Account: The auditor should ensure that **debit balances** are not set off against credit balances on current account. He should also pay special attention to inoperative accounts which are common areas of frauds.
b. Saving Accounts: The auditor should verify that the **total of subsidiary ledger** balances tallies with control account in general ledger. The calculation of interest should be checked on sample basis.
c. Term Deposits: The auditor should satisfy himself about the proper **custody** of unused deposit certificates and that they are issued serially. The auditor should verify the **counterfoils** of deposit certificates with the relevant register.
d. Deposits designated in foreign currency: The auditor should examine the **rates used** for converting them into Indian rupees. It should be noted that interest accrued but not due should be shown under other liabilities and not under deposits.

ix) Borrowings - The auditor may verify the borrowings in the following manner:
a. Borrowings from **R.B.I**. may be verified from the confirmation certificate from R.B.I
b. Rediscounting of bills is **not shown** under this head.
c. Borrowings of money at **call and short notice** should be examined for proper authorization and reasonableness of the terms and conditions.

x) Other Liabilities and Provisions - The following items are disclosed under this head.
a. Bills Payable **b.** Inter Office Adjustments **c.** Interest Accrued but not Due **d.** Others

The auditor may verify the above items in the following manner:-
Bills Payable - Bills Payable include demand drafts, telegraphic transfers, and travelers' cheques, issued by the bank but not presented for payment till the Balance Sheet date. The auditor is generally concerned with • the existence of adequate control system regarding issuance and payment of these bills; and • Old outstanding entries for payment of bills for which no advice has been received.
Inter Office (Inter Branch) Adjustments - The balance of inter office adjustments accounts, if in credit are to be shown under this head.
Others (Including Provisions) - The following items are included under this head:
• Net provision for tax • Surplus in aggregate in provisions for bad and doubtful debts provision account. • Surplus in aggregate in provision for depreciation in securities.

• Contingency funds which are in the nature of provisions but are not disclosed as such.
• Provisions towards standard assets. • Proposed dividend/transfer to Government.

xi) Contingent Liabilities - In case of Contingent liabilities, the Auditor should generally follow the audit procedure given below:
• Examine the system of authorization and internal controls relevant to contracts giving rise to Contingent Liabilities • Ascertain the maintenance of adequate record. • Perform substantive test to establish completeness of recorded obligation. • Obtain representation from the management that all the Contingent liabilities have been identified, quantified and do not include items likely to result in a loss.

The Procedure to Verify the Various Elements of Contingent Liabilities:
i) Claims against the Bank Not Acknowledged as Debt - • Examine external evidences like Correspondence with Lawyers, claimants etc. • Review the minutes of board meetings. • obtain representation from the management about the status of such claims. • Review the subsequent events.

ii) Liability on Partly paid Shares - Examination of Certificates of investment is the best procedure to ascertain such liabilities.

iii) Liability on outstanding Forward Exchange Contracts - The auditors may verify these liabilities with the registers maintained and copies of broker's advice notes.

iv) Guarantees given on behalf of Constituents - • The auditor should ascertain adequacy of internal control over issuance of guarantees, e.g. whether guarantees are issued under proper sanction, whether margins are taken from customer's etc. • the auditor should ascertain that unused guarantee forms are in proper custody. • Substantive test of guarantees given may be performed through the guarantee register.

v) Acceptances, Endorsements and other Obligations - These include letters of credit issued and bills discounted or purchased by the bank. The audit procedure should involve evaluation of internal control system and verification of the relevant registers and copies of letter of credit issued.
Letters of credit: •Evaluate the adequacy of the internal controls over LC Forms e.g. custody, maintenance of records, periodical verification, reconciliation etc. • Verify the balance of LC from the Register maintained by the bank to ascertain the amount of LC and payments made under them. • Examine the guarantees of the customers, copies of the LC issued & security obtained for issuing LC.
In respect of other acceptances and endorsements the following procedure may be adopted:
• Examine the arrangements made by the bank with its customers. • Test checks the amounts of bills with the register maintained by the bank. • Verify whether such bills are marked off in the register on payment at maturity.
Letters of comfort: Where letters of comfort has been issued, verify whether the bank has incurred a potential financial obligation under such a letter. If an obligation has been cast under letters of comfort, ensure that the amount has also been shown as contingent liability in the Balance Sheet.
vi) Bills for Collection - These are to be shown at the foot note of the Balance Sheet. The audit Procedure should involve: • Verification of the bills for collection on hand.
• Examination of Collections subsequent to Balance sheet date. • Examination of Procedure for recognition of income on such services. Income should be recognized only of collection of the bills.

11.9 Concurrent Audit - "Audit or verification of transactions or activities of an organization concurrently as the transaction or activity takes place."
i) It is early warning system for timely detection of irregularities
ii) It is done on regular Basis.
iii) Mandatory for Banks to cover at least:
• 50% of total deposits & • 50% of total advances
iv) Following should be considered:
• Large / very Large branches • Special branches • Large problem branches • H.O. department dealing with treasury/funds management & handling Investment Portfolio • Any other branch/department at discretion of bank
v) It can be undertaken by internal inspection staff or independent C.A.

Objectives of Concurrent Audit - Its objective is to see whether transactions or decisions are within the policy parameters laid down by H.O., they don't violate instructions of RBI & they are within authority.

Scope/Areas of Concurrent Audit
i) Cash
• Any abnormal receipts and payments • Proper accounting of cash remittances
• Proper accounting of cash receipts • Expenses by cash involving sizeable amount.
ii) Investment
• Purchase and sale of securities within its delegated power. • Securities held in the books of the branch are physically held by it. • Investments are as per RBI's guidelines. • Sale or purchase transactions are done at beneficial rates.
iii) Deposits
• Check the transactions about deposits received and repaid. • Test check of interest paid on deposits. • Check new accounts opened.
iv) Advances
• Ensure that loans and advances have been sanctioned properly. • Whether the sanctions are as per delegated authority. • Securities and documents have been received and properly charged. • Post disbursement supervision and follow-up is proper or not. • Whether the letters of credit issued by the branch are within the delegated power. • Check the bank guarantees issued. • Proper follow-up of overdue bills of exchange. • Verify classification of advances. • Verify that instances of exceeding delegated powers have been promptly reported to controlling / Head Office.
v) Foreign Exchange
• Check foreign bills • Whether inward/outward remittance have been properly accounted for. • Check extension and cancellation of forward contracts for purchase and sale of foreign currency. • Ensure that balances in Nostro accounts in different foreign currencies are within the limit. • Ensure adherence to the guidelines issued by RBI. • Ensure verification/reconciliation of Nostro and Vostro account.
vi) Housekeeping
• Ensure maintenance and balancing of accounts. • Carry out a test check of calculations of interest, discount, commission and exchange. • Check the transactions of staff accounts.
• Detection and prevention of revenue leakage. • Check cheques returned/bills returned.
vii) Other Items
• Ensure that the branch gives proper compliance to the internal inspection/audit reports.
• Customer's complaints are dealt with promptly. • Verification of statements, returns, statutory returns.

Remuneration of auditor - It is fixed by bank.
Irregularities - Minor irregularities to be rectified on the spot. Serious irregularities reported to H.O. /Z.O.

Reporting - Proper reporting & at proper interval. Reported on 10th of next month/quarter but flash report can be submitted immediately. Normally, the audit report should be divided in **three parts**. The **'first part'** should deal with major irregularities. The **'second part'** should deal with minor irregularities which have not been attended during the course of audit. The **'last part'** should deal with compliance with earlier reports. Before submission of the report the auditor should discuss the important issues on which he wishes to report with the branch manager and concerned officers.

11.10 Vostro & Nostro A/C

- Forex account **maintained by Indian Bank** at other **overseas centers** in NOSTRO.
- VOSTRO is **opposite** of NOSTRO, i.e. **foreign Bank** in another country **maintain** Indian rupees **with their Indian correspondent** local banks. E.g. German Bank maintaining VOSTRO in rupees with Indian Bank
- Check the **reconciliation.**
- Check **Internal controls** w.r.t. inward/outward messages
- Balance **confirmation** certificate to be received, from such another bank.

11.11 Audit Of Compliance With SLR Requirement - Statutory Central Auditor to **verify** compliance with SLR requirements on **12 odd dates** in **different months** of a financial year not being Fridays. Report is given to Management and RBI. Examination has 2 Aspects: **i)** Correctness of figures of **DTL** (Demand & Time Liabilities) on **reporting Friday** (last Friday of second preceding fortnight), **ii)** Maintenance of **liquid asset** on selected date.

11.12 Capital Adequacy

i) Meaning: It is a measure of the adequacy of an entity's capital resources in relation to its current liabilities and also in relation to the risks associated with its assets. An appropriate level of capital adequacy ensures that the entity has sufficient capital to support its activities and that its net worth is sufficient to absorb adverse changes in the value of its assets without becoming insolvent. For example, under BIS (Bank for International Settlements) rules, banks are required to maintain a certain level of capital against their risk-adjusted assets. All Indian scheduled commercial Banks (excluding RRB) & foreign Banks operating in India to maintain CA Ratio at a minimum of 9% (**Master Circular - Prudential norms for Capital Adequacy - Dated 2nd July, 2012**).

ii) Formula

$$\textbf{Capital Adequacy Ratio} = \frac{\text{Capital Funds}}{\text{Risk Weighted Assets \& off B / S Items}} \times 100$$

a. Tier I Capital = (Paid up capital + St. reserve + disclosed free Reserves) - (Equity investments in subsidiary + Intangible Assets + current & B/f loss)

b. Tier II Capital = It includes following i.e. undisclosed Reserve, General Provision & Loss reserves, Hybrid debt capital instruments & subordinated debt.

Tier II Capital can be maximum 100% of Tier I capital.

Various assets are taken after exposing to varying degrees of risk as specified.

11.13 Guidelines Of The Reserve Bank Of India On Asset Classification, Income Recognition, Provisioning And Other Related Matters

Non-Performing Assets - An asset, including a leased asset, becomes non performing when it **ceases to generate income** for the bank.

A non performing asset (NPA) is a **loan or an advance** where:

i) Interest and/or installment of principal remain **overdue for** a period of **more than 90 days** in respect of a term loan.

ii) An **Overdraft/Cash Credit** become NPA (out of order) in **following circumstances**:
• if the outstanding balance remains **continuously** in **excess of the sanctioned limit** or the drawing power, or • If there are **no credits** continuously for 90 days as on the balance sheet date or the credits are not enough to cover the interest debited during the same period.

iii) The **bill remains overdue** for a period of more than 90 days in the case of bills purchased and discounted.

iv) The installment of principal or interest thereon remains overdue for **two crop seasons** for **short** duration crops.

v) The installment of principal or interest thereon remains overdue for **one crop season** for **long** duration crops.

vi) The amount of liquidity facility remains outstanding for more than 90 days, in respect of a **securitization transaction** undertaken in terms of guidelines on securitization dated February 1, 2006.

vii) in respect of **derivative transactions**, the overdue receivables representing positive mark-to-market value of a derivative contract, if these remain unpaid for a period of 90 days from the specified due date for payment.

viii) Any amount to be received remains overdue for a period of more than 90 days in respect of **other accounts**.

Classification Norms Relating To NPAs

Temporary Deficiencies – In The Matter Of Classification of Accounts with Temporary Deficiencies, Banks Have to Follow the **Following Guidelines**:
i) Banks should ensure that drawings in the working capital account are **covered by the adequacy of the current assets**. Drawing power is required to be arrived at based on current stock statement. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months.

ii) The outstanding in the account based on **drawing power** calculated from stock statements older than three months is deemed as irregular.

iii) A **working capital borrowing account** will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.

iv) The accounts where **regular/ad hoc credit limits** have not been reviewed/renewed within 180 days from the due date/date of ad hoc sanction, the account should be treated as NPA.

Classification of Advances - The Guidelines Require Banks to Classify Their Advances into Four Broad Categories For The Purpose Of Provisioning As Follows:
i) Standard assets - A standard asset is one which does not disclose any problems and which does not carry more than **normal risk** attached to the business. Such an asset is not a non-performing asset.

ii) Sub-standard assets - With effect from March 31, 2005, a sub-standard asset is one which has remained **NPA** for a period less than or equal to **12 months**. In such cases, the current net worth of the borrower/guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the bank in full.

iii) Doubtful assets - With effect from March 31, 2005, an asset is classified as doubtful if it has remained in the **sub-standard category for a period of 12 months**. Such an asset has all the inherent weaknesses as in a doubtful asset and an added characteristic that the weaknesses make the collection or liquidation in full highly improbable or questionable.

iv) Loss assets - A loss asset is one where loss has been **identified by** • the bank • the internal or external auditors • the RBI inspection, but the amount has not been written off wholly.

Upgradation of Loan Accounts Classified as NPAs - If arrears of **interest and / installment are paid** by the borrower through genuine source, in the case of loan accounts classified as NPAs, the account should no longer be treated as non-performing and may be classified as 'standard' accounts.

Treatment of NPAs - Borrower-wise and not Facility-wise:
i) In respect of a borrower having more than one facility with a bank, all the facilities granted by the bank will have to be treated as NPA and not the particular facility or part thereof which has become irregular.

ii) However, in respect of consortium advances or financing under multiple banking arrangements, each bank may classify the borrowal accounts according to its own record of recovery and other aspects having a bearing on the recoverability of the advances.

Credit facilities Guaranteed by Central / State Government: The credit facilities backed by guarantee of the C.G. though overdue should **not be treated as NPA.** This exemption from classification of government guaranteed advances as NPA is not for the purpose of recognition of income. From the year ended March 31, 2006, State Government guaranteed advance and investment in State Government guaranteed securities **would attract** asset classification and provisioning norms.

Project Financing: 'Project Loan' would mean any term loan which has been extended for the purpose of setting up of an economic venture. Banks must fix a Date of Commencement of Commercial Operations (DCCO) for all project loans at the time of sanction of the loan / financial closure (in the case of multiple banking or consortium arrangements).For the purpose of Income Recognition and Asset Classification norms, all project loans may be divided into the following two categories; (i) Project Loans for infrastructure sector (ii) Project Loans for non-infrastructure sector. Detailed guidelines are given in Annex 9.In the case of bank finance given for industrial projects where moratorium is available for payment of interest, payment of interest becomes due only after the moratorium or gestation period is over. Therefore, such amounts of interest do not become overdue and hence NPA, with reference to the date of debit of interest. They become overdue after due date for payment of interest, if uncollected.

Provisioning for Loans and Advances - The specific requirements of the Circular in respect of provisioning are as follows:
i) Loss assets - The **entire amount** should be **written off**. If the assets are permitted to remain in the books for any reason, 100 percent of the outstanding should be provided for.

ii) Doubtful assets - The provisioning for doubtful assets under loans and advances is as under • **Full provision** to the extent of the **unsecured portion** should be made. In doing so, the realizable value of the security available, to which the bank has a valid recourse, should be determined on a realistic basis. • In regard to the **secured portion**, provision may be made on the following basis, at **the rates** ranging from **20% to 100% of secured portion** depending upon the period for which the asset has remained doubtful.

Period for which the advance has been considered as doubtful	% of provision on secured portion
Up to 1 year	25%
More than 1 year and up to 3 years	40%
More than three years	100%

iii) Sub-standard assets

• A **general provision** of **15 percent** on total outstanding should be made without making any allowance for ECGC guarantee cover and securities available.
• The "unsecured exposures" which are identified as "substandard" would attract additional provision of 10%, i.e., a total of 25% on the outstanding balance. However, "unsecured exposures" in respect of infrastructure Loan accounts classified as sub-standard will attract a provisioning of 20% instead of 25%.

iv) Standard Assets

• Banks should make general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis:
~ Direct advances to agricultural and SMEs sectors at 0.25 per cent;
~ advances to Commercial Real Estate (CRE) Sector at 1.00 per cent;
~ Housing loans extended at 2% and
~ Restructured Advances***** as indicated below:
~ All other loans and advances not included above at 0.40 per cent
• It is clarified that the Medium Enterprises will attract 0.40% standard asset provisioning.
• The provisions on standard assets should not be reckoned for arriving at net NPA5.
• The provisions towards Standard Assets need **not be netted** from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions Others' in Schedule V of the B/S.

***Restructured Advances**

→ Restructured accounts classified as standard advances will attract a provision of 2 per cent in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract a provision of 2 per cent for the period covering moratorium and two years thereafter; and
→ Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a provision of 2 per cent in the first year from the date of upgradation

Income recognition in case of NPA - In case if NPA, the interest is recognized when it is actually received and not on accrual basis except for advances secured by NSCs, IVPs, KVPs, and life Insurance policies having adequate margin.
Provisioning for Certain Specific Types of Advances - The **guidelines** also deal with provisioning for certain specific types of advances as follows:
Advances Granted Under Rehabilitation Packages - In respect of advances under rehabilitation package approved by BIFR/term lending institutions, banks are required to **continue with the provision** to be made in respect of dues to the bank on the existing credit facilities as per their classification as substandard or doubtful asset. As regards the

additional facilities sanctioned as per package finalized by BIFR and/or term lending institutions, **provision on additional facilities sanctioned** need **not be made** for a period of **one year** from the date of disbursement.

Advances Guaranteed by ECGC - In the case of advances guaranteed by ECGC, provision should be made only for the **balance in excess** of the amount of such **guarantee**. Further, while arriving at the provision required to be made for doubtful assets, realizable value of the securities should first be deducted from the outstanding balance in respect - of the amount guaranteed by these Corporations and then provision should be made.

Advance covered by CGTSI (Credit Guarantee Fund Trust for Small Industries) - In case the advance covered by CGTSI guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in **excess** of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non- performing advances.

	Category of Standard Asset	**Rate Of Provisioning**
Standard Assets	Direct Advances to agricultural & SME	0.25%
	Commercial Real Estate Sectors(for UCBs)	1.00 %
	All other loans and advances not included above	0.40 %
Sub-Standard Assets	15 % of total O/S% + 10% on unsecured exposure	
Doubtful Assets	**Unsecured portion**	100 %
	Secured Portion:	
	< 1 year	20 %
	1 to 3 Year	30 %
	> 3 Years	100 %
Loss Asset		100%
Govt. guaranteed advance becomes NPA		Normal Provisions
Advance against TD, NSC KVP, LIP, IVP becomes NPA		Normal Provisions
Advance covered by ECGC/DICGC		Provision for Excess Only

Restructuring/Re-Schedulement Of Loans {Including Under Corporate Debt Structuring (COR) Scheme}

Eligibility criteria for restructuring of advances - Banks may restructure the accounts **classified** under 'standard', 'sub-standard' and 'doubtful' categories. Banks cannot reschedule / restructure / renegotiate borrowal accounts with retrospective effect. No account can be taken up for restructuring by the banks unless the **financial viability** is established and there is a reasonable **certainty of repayment** from the borrower, as per the terms of restructuring package. The viability should be determined by the banks based on the acceptable viability **benchmarks determined** by them, which may be applied on a case by case basis, depending on merits of each case. The parameters may, for example, include: • Return on Capital Employed • Debt Service Coverage Ratio • Gap between the Internal Rate of Return and Cost of Funds and the amount of provision required in lieu of the diminution in the fair value of the restructured advance.

Provisioning Norms - Banks is required to hold provision against the restructured advances **as per the existing provisioning norms**.

Prudential Norms for Conversion of Principal into Debt/Equity
Asset Classification Norms - A part of the outstanding principal amount can be converted into debt or equity instruments as part of restructuring. The debt/equity instruments so created will be classified in the same asset classification category in which the restructured advance has been **classified**. • Income Recognition Norms • Standard Accounts
In the case of restructured accounts classified as 'standard', the income, if any, generated by these instruments may be recognized on accrual basis.
Non- Performing Accounts - In the case of restructured accounts classified as non-performing assets, the income, if any, generated by these instruments may be recognized only **on cash basis.**

Organizational Framework for Restructuring of Advances under Consortium/ Multiple Banking/ Syndication Arrangements
i) Corporate Debt Restructuring (CDR) Mechanism
A Corporate Debt Restructuring system has been evolved for restructuring of the corporate debts of viable entities facing problems, which are outside the purview of BIER, DRT and other legal proceedings. All the banks have been advised by RBI to follow the Corporate Debt Restructuring mechanism, which would be a **non-statutory voluntary system** based on debtor creditor agreement and inter creditor agreement. The RBI has issued **separate guidelines** in respect of debt restructuring for small and medium enterprises (SMEs).
The RBI has also suggested that in order to improve effectiveness of the CDR mechanism a clause may be incorporated in the loan agreements involving consortium/syndicate accounts whereby all creditors, including those which are not members of the CDR mechanism, agree to be bound by the terms of the restructuring package that may be approved under the CDR mechanism, as and when restructuring may become necessary.
Corporate Debt Restructuring (CDR) would generally affect the **operations** both at Branch level as well as the Head office level, although, in most of the cases the effects of provisioning due to sacrifice in the interest would be made at the Head Office level.
One of the **main features** of the restructuring under CDR system is the provision of **two categories** of debt restructuring under the CDR system. Accounts, which are classified as 'standard' and 'substandard' in the books of the creditors, will be restructured under the first category (**Category 1**). Accounts which are classified as 'doubtful' in the books of the creditors would be restructured under the second category (**Category 2**).

ii) Debt Restructuring Mechanism for Small and Medium Enterprises (SMEs)
Apart from CDR Mechanism, RBI has also prescribed a separate scheme for restructuring of loans availed by Small and Medium Enterprises (SME5). This mechanism will be applicable to all the borrowers which have funded and **non-funded** outstanding up to Rs.**10 crore** under multiple/consortium banking arrangement. **Major elements** of this arrangement are as under:
• under this mechanism, banks may formulate, with the **approval** of **BOD**, a debt restructuring scheme for SMEs within the prudential norms laid down by RBI. Banks may frame different sets of policies for borrowers belonging to different sectors within the SME if they so desire.
• While framing the scheme, banks may ensure that the scheme is **simple** to comprehend and will, at the minimum, include parameters indicated in these guidelines.
• The main plank of the scheme is that the bank with the **maximum outstanding** may work out the restructuring package, along with the bank having the second largest share.
• Banks should work out the **restructuring package and implement** the same within a maximum period of 90 days from date of receipt of requests.
• The SME Debt Restructuring Mechanism will be **available to all borrowers** engaged in

any type of activity.
• Banks may **review** the progress in rehabilitation and restructuring of SMEs accounts on a quarterly basis and keep the Board informed.

11.14 Basel II - Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. Basel II, initially published in June 2004, was intended to create an international standard for banking regulators to control how much capital banks need to put aside to guard against the types of financial and operational risks banks (and the whole economy) face.

Basel II uses a "**three pillars**" concept – **(1)** minimum capital requirements (addressing risk), **(2)** supervisory review and **(3)** market discipline.

The First Pillar: Minimum Capital Requirements (Addressing Risk) - The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: **A.** credit risk, **B.** operational risk, **C.** market risk, and **D.** Other risks.

A. The credit risk component can be calculated in three different ways of varying degree of sophistication, **(a)** standardized approach, **(b)** Foundation IRB and **(c)** Advanced IRB. IRB stands for "Internal Rating-Based Approach".

B. For operational risk, there are three different approaches – **(a)** basic indicator approach, **(b)** standardized approach, and **(c)** the internal measurement approach.

C. For market risk the preferred approach is VAR (value at risk).

D. Other risks are not considered fully quantifiable at this stage.

The standardized approach sets out specific risk weights for certain types of credit risk. The standard risk weight categories used under Basel 1 were 0% for government bonds, 20% for exposures to OECD Banks, 50% for first line residential mortgages and 100% weighting on consumer loans and unsecured commercial loans. Basel II introduced a new 150% weighting for borrowers with lower credit ratings. The minimum capital required remained at 8% of risk weighted assets, with Tier 1 capital making up not less than half of this amount. Banks that decide to adopt the standardised ratings approach must rely on the ratings generated by external agencies. Certain banks used the IRB approach as a result.

The Second Pillar: Supervisory Review - The second pillar deals with the regulatory response to the first pillar, giving regulators much improved 'tools' over those available to them under Basel I. It also provides a framework for dealing with all the other risks a bank may face, such as systemic risk, pension risk, concentration risk, strategic risk, reputational risk, liquidity risk and legal risk, which the accord combines under the title of residual risk. It gives **banks a power to review** their risk management system. Internal Capital Adequacy Assessment Process (ICAAP) is the result of Pillar II of Basel II accords.

The Third Pillar: Market Discipline - This pillar aims to complement the minimum capital requirements and supervisory review process by developing a set of disclosure requirements which will allow the market participants to gauge the capital adequacy of an institution.
Recent Development in India - RBI has issued a circular on prudential guidelines on capital adequacy and market decisions dated 1st July 2011 for implementation of Basel II.

CASE STUDIES

Q1. What are the principal enactments governing bank audit?
Hint Ans: Refer to Point No. 11.1

Q2. As a branch auditor of a nationalised bank, how would you verify the following?
(1) Bills Purchased and Discounted

(2) Third Party Guarantees

Ans: (1) Verification of Bills Purchased and Discounted

(a) The auditor should ascertain that the **policy framed by the bank** conforms to the requirements laid down by the RBI.

(b) Bills purchased and discounted have to be shown separately in the balance sheet as a part of '**advances**'. Further, under the head 'advances outside India' in the balance sheet, bills purchased and discounted outside India have to be shown separately.

(c) In certain eligible cases, the bills purchased or discounted by the bank may be rediscounted by it with the RBI IDBI/SIDBI. Such bills would not be included under advance but would constitute a **contingent liability**.

(d) The auditor should **examine and satisfy** himself that: • all the outstanding bills have been taken in the balance sheet; • all the details, including the nature of the bills and documents are mentioned in the register and that the bills have been correctly classified; • the bills purchased or discounted from different parties are in accordance with the agreements with them and the total of outstanding bills of each party is not in excess of the sanctioned limit; • the bills are not overdue. If there are any overdue bills, the auditors should ascertain the reasons for delay and the action taken by the bank.

(e) The auditor should examine whether **registers of bills purchased and discounted** are properly maintained and the transactions are recorded therein correctly.

(f) Auditor should also examine whether the bills and the **documents accompanying the bills** are properly endorsed and assigned in favour of the bank.

(2) Verification of Third Party Guarantees

(a) The auditor should examine the **guarantee bonds** and the demand promissory notes in order to verify the third party liability.

(b) The auditor should also satisfy himself that the guarantee **is in force as at the date** of the balance sheet.

(c) In the absence of a provision to the contrary, a **guarantee terminates by revocation** or upon death of the surety. The surety is also discharged (unless there is a specific covenant to the contrary) if the creditor arranges with the principal debtor for composition, or agrees to give time or agrees not to sue him, without consulting the surety.

(d) If any **variation is made** in the **terms of the contract** between the principal debtor and the creditor without the surety's consent, it discharges the surety as to transactions subsequent to the variation.

(e) The **guarantee forms** used by banks normally seek to ensure the continuing obligation of the guarantor in spite of these contingencies.

Q3. As a branch auditor of a nationalised bank, how would you verify the following?
(1) Advances to DOT COM Companies.
(2) Balances in account of a bank situated in a foreign country.

Hint Ans: (1) Refer Point No. 11.8 (iii-k) & (iii-k-1)

(2) (i) Verify the ledger balances in each account with reference to the bank confirmation certificates and reconciliation statements as at the year-end.

(ii) Review the reconciliation statements and examine that no debit for charges or credit for interest is outstanding and all the items which ought to have been taken to revenue for the year have been so taken, no cheque sent or received in clearing is outstanding, all bills or outstanding cheques sent for collection and outstanding as on the closing date have been credited subsequently.

(iii) Examine the large transactions in inter-bank accounts, particularly towards the year-end, to ensure that no transactions have been put through for window-dressing.

(iv) Check original deposit receipts in respect of balances in deposit accounts in addition to confirmation certificates obtained from banks in respect of outstanding deposits.

(v) Check whether these balances are converted into the Indian currency at the exchange rates prevailing on the balance sheet date and ensure compliance with AS 11 on "The Effects of Changes in Foreign Exchange Rates".

Q4. As the concurrent auditor of Nagpur Main Branch of XYZ Bank Ltd. state the issues which have to be considered in the audit of advances.
Hint Ans: Refer Point No. 11.9 – (Scope/Areas of Concurrent Audit – iv)

Q5. Your firm has been appointed as Central Statutory Auditors of a Nationalised Bank. The Bank follows financial year as accounting year. State your views on the following issues which were brought to your notice by your Audit Manager:
(a) The bank has recognised on accrual basis income from dividends on securities and Units of Mutual Funds held by it as at the end of financial year. The dividends on securities and Units of Mutual Funds were declared after the end of financial year.
(b) The bank is a consortium member of Cash Credit Facilities of Rs. 50 crores to X Ltd Bank's own share is Rs. 10 crores only. During the last two quarters against a debit of Rs. 1.75 crores towards interest the credits in X Ltd's account are to the tune of Rs. 1.25 crores only. Based on the certificate of lead bank, the bank has classified the account of X Ltd as performing.
(c) In case of all such advances which have been classified as non-performing for the first time during the current financial year, only the last date of the financial year has been reckoned as the date of account becoming non-performing.
Hint Ans: (a) Banks may book income from dividend on shares of corporate bodies on accrual basis, provided dividend on the shares has been declared by the corporate body in its annual general meeting and **the owner's right to receive payment is established**. This is also in accordance with **AS 9** as well. In the instant case, the recognition of income by the bank on accrual basis is not in order
(b) In case of consortium, each bank may classify the advance given by it according to its own experience of recovery and other factors. Since in the last two quarters, the amount remains outstanding and, thus, interest amount should be reversed. This is despite the certificate of lead bank to classify that the account as performing. Accordingly, the amount should be shown as non-performing asset.
(c) It is wrong to take the Balance Sheet date for purposes of classification. In this context, it is important to note the concept of past due. An amount should be considered as past due when it remains outstanding for more than 90 days beyond due date. For example, if any SSI loan amount, the repayment of term loan installment falls due for payment on December 31 and is not paid; the amount would become past due if it remains unpaid for more than 90 days beyond that date. As per RBI Master Circular on Guidelines of the RBI on Asset Classification, Income Recognition, Provisioning dated 02 July 2012. if the account of the borrowers have been regularised before the balance sheet date by repayment of overdue amounts through **genuine sources and not by sanction of additional facilities**, the account need not be treated as NPA in spite of payment of interest and installment were in arrear for 90 days. Bank should, however, ensure that the account remains in order subsequently.

Q6. While auditing the Branch of a Bank you are required to examine Inter Branch adjustments. Which points require your special attention?
Hint Ans: Refer to Relevant Part of Point No. 11.8 (v)

Q7. How do you examine claims against the Bank not acknowledged as debts?
Hint Ans: Refer to Point No. 11.8 (xi)

Q8. Feel Good Bank Ltd. appoints Secure & Co, a firm of CAs for a special assignment of ascertaining the quality of its loans and advances portfolio independently. What would be the areas you would focus on such a review?
Hint Ans: **Refer** Point No. 11.8 (iii-k)

QUESTIONS

Q1. What do you understand by Long-form Audit Report? (2 Marks) **(Nov 2008)**

Q2. As the concurrent auditor of Nagpur Main Branch of XYZ Bank Ltd. state the issues which have to be considered in the audit of advances. (6 Marks) **(Nov 2008)**

Q3. How will you evaluate the Internal Control system in the area of Credit Card operations of a Bank? (5 Marks) **(Nov 2009)**

Q4. While auditing the Branch of a Bank you are required to examine Inter Branch adjustments. Which points require your special attention? (6 Marks)

Q5. How do you examine claims against the Bank not acknowledged as debts? (4 Marks) **(May 2010)**

Q6. Write a short note on reversal of income under bank audit. (5X4 Marks) **(Nov 2010)**

Q7. "An asset, including a leased asset, becomes non-performing when it ceases to generate income for the Bank." Define the criteria for classification of non-performing assets. (8 Marks) **(May 2011)**

12. AUDIT OF GENERAL INSURANCE COMPANIES

12.1 Legal Framework - It is important for the auditor to familiarise himself with various statutes governing the insurance industry. Various aspects relating to audit are dealt with around the framework of the following statutes and rules made there under:
i) The Insurance Act, 1938 (including Insurance Rules, 1939);
ii) The Insurance Regulatory and Development Authority Act, 1999;
iii) The Insurance Regulatory and Development Authority Regulations framed under IRDA, Act, 1999;
iv) The Companies Act, 1956; and
v) The General Insurance Business (Nationalisation) Act, 1972 (including Rules framed there under).

12.2 Features of Accounting System of Insurance Companies - The functions of accounting system in general insurance business under IT environment may be based on: Underwriting module, Claims module, Agency management module, Accounts module, Investment module, Reinsurance module

i) Form and Contents of Financial Statements - Every insurer, in respect of insurance business transacted and in respect of shareholder's funds, is required to prepare a **Balance Sheet,** a Profit and Loss Account, a separate Account of Receipts and Payments, a Revenue Account for each year in accordance with the **Regulations** made by the Authority. Sub-section 1B of section 11, of the Insurance Act, 1938, specifies that every insurer should keep **separate account**s relating to funds of shareholders and policyholders. The Authority, has issued regulations for the preparation of the financial statements and auditor's report of companies carrying on insurance business.
The Regulations contain **three schedules**. **'Schedule A'** is applicable to companies carrying on life insurance business. **'Schedule B'** of the Regulations lays down the accounting principles, disclosures forming part of financial statements, general instructions for preparation of financial statements, the contents of the management report and the formats in which the financial statements of an insurer carrying on general insurance business should be drawn up. Schedule B is in **five parts**, covering various aspects related to the preparation of financial statements, which form the main basis for preparation of financial statements of general insurance companies. The five parts have been outlined in the following paragraphs. **'Schedule C'** to the Regulations lays down the matters to be dealt with by the auditor's report of an insurance company. Schedule C is applicable to insurers carrying on general insurance business as well as life insurance business.

ii) Requirements of Schedule B to the IRDA (Preparation of Financial Statements and Auditors' Report of Insurance Companies) Regulations, 2002 –
a. Part I – Accounting Principles for Preparation of Financial Statements
• **Applicability of AS** - Every FS shall be in conformity with the AS except that:

Applicable Standards	Standards Not Applicable
AS 3: "Cash Flow Statements" – As per Direct Method only	**AS 4:** Not applicable (N.A.) w.r.t. liabilities arising out of I. Policies
AS 17: "Segment Reporting" - shall apply to all insurers irrespective of the requirements regarding listing and turnover mentioned therein.	**AS 9:** N.A. w.r.t. incomes of insurance business
	AS 13: "Accounting for Investments"

• **Premium** - Premium shall be recognised as income over the contract period or the period of risk, whichever is appropriate.
• **Premium Deficiency** - It shall be recognised if the sum of expected claim costs, related expenses and maintenance costs exceeds related reserve for unexpired risks.
• **Acquisition Costs** – 'Acquisition costs' are those costs that vary with, and are primarily

related to, the acquisition of new and renewal insurance contracts. Acquisition costs, if any, shall be expensed in the period in which they are incurred.
• **Claims** - A liability for outstanding claims shall be brought to account.
• **Valuation of Investment** –
~ Real Estate - Investment property – Shall be measured at Historical cost less accumulated depreciation less impairment loss. Residual value being considered as zero.
~ Debt Securities - Shall be considered as 'held maturity' & valued at Historical cost.
~ Equity / Derivative Traded in Active Market – Shall be measured at Fair Value as at B/S date. Impairment loss shall be taken as expenses. Unrealised gains/losses arising due to changes in F.V. shall be taken to "Fair Value change A/c."
~ Unlisted and other than actively traded Equity Security & Derivative Instruments – Shall be measured at Historical Cost. Provision shall be made for diminution in value of such investments. Such provision may be reversed in subsequent years but increased carrying amount shall not exceed its historical cost.
• **Loan** – Shall be measured at historical cost subject to impairment provision.
• **Catastrophe Disaster Reserve** - Shall be created as per norms prescribed by authority.

b. Part II: Disclosures forming part of Financial Statements
The following shall be disclosed by way of notes to the Balance Sheet -
• Contingent Liabilities: The following needs to be disclosed:
~ Partly paid investments
~ Underwriting commitments outstanding
~ Claims, other than those under policies, not acknowledged as debts
~ Guarantees given by or behalf of the company
~ Statutory demand /liabilities in dispute, not provided for
~ Reinsurance obligations to the extent not provided for in accounts
~ Others (if any to be specified)
• Encumbrances to assets of the company in and outside India.
• Commitments made and outstanding for Loans, Investments and Fixed Assets.
• Claims, less reinsurance, paid to claimants in/outside India.
• Actuarial assumptions for determination of claim liabilities in the case of claims where the claims payment period exceed four years.
• Ageing of claims – distinguishing between claims outstanding for more than six months and other claims.
• Premiums, less reinsurance, written from business in/outside India.
• Extent of premium income recognised, based on varying risk pattern, category wise, with basis and justification, including whether reliance has been placed on external evidence.
• Value of contracts in relation to investments
• Operating expenses relating to insurance business: basis of allocation of expenditure to various classes of business.
• Historical costs of those investments valued on fair value basis.
• Computation of managerial remuneration.
• Basis of amortisation of debt securities.
• Unrealised gain/losses arising due to changes in the fair value of listed equity shares and derivative instruments are to be taken to equity under the head 'Fair Value Change Account' and on realisation reported in profit and loss Account.
• Pending realisation, the credit balance in the 'Fair Value Change Account' is not available for distribution.
• Fair value of investment property and the basis therefore.
• Claims settled and remaining unpaid for a period of more than six months as on the balance sheet date.

c. Part III: General Instructions for Preparation of Financial Statements

• The corresponding amounts for last year should be given.
• The figures in the financial statements may be rounded off to the nearest thousands.
• Interest, dividends and rentals receivable should be stated as gross value, the amount of TDS being included under 'advance taxes paid'.
• Income from rent shall not include any notional rent.
• The company should make provisions for damages under lawsuits where the management is of the opinion that the award may go against the insurer.
• Extent of risk retained and reinsured shall be separately disclosed.
• Any debit balance of P&L A/c shall be shown as deduction from uncommitted reserves and the balance if any, shall be shown separately.

d. Part IV: Contents of Management Report – It should contain:

• Confirmation for validity of registration granted by the Authority.
• Certification that all statutory dues have been paid to the Authority.
• Confirmation that shareholding pattern is in accordance with statutory requirements.
• Confirmation that **solvency margin*** has been maintained.
• Confirmation that valuation of Investment is as per norms as on the B/S Date.
• Confirmation that management has not invested any money outside India.
• Confirmation about overall risk exposure has been disclosed.
• Confirmation about operation in other countries
• Confirmation about aging of claims indicating the trends in average claims.
• Confirmation about quality of asset & performance of investment in terms of portfolio.
• Confirmation about payment to parties in which director is interested
• Responsibility statement.

***Solvency Margin** **(Applicable to GIC)** maintains excess of assets over amount of its liabilities at all times, **higher** of following:

• 50 crores (100 Cr. For reinsurer)
• 20% of net premium income.
• 30% of net incurred claims.

If **non-maintenance of S.M.,** insurer to submit a financial plan to authority indicting plan of action, else it shall deemed to be insolvent and wound up by court.

e. Part V: Preparation of Financial Statements

• An insurer shall prepare the **Revenue Account, Profit and Loss Account** [Shareholders' Account] and the Balance Sheet in Form B-RA, Form B-PL, and Form B-BS, or as near thereto as the circumstances permit.

Provided that an insurer shall prepare **Revenue Accounts separately** for fire, marine, and miscellaneous insurance business and **separate schedules** shall be prepared for Marine Cargo, Marine – Other than Marine Cargo.

• An insurer shall prepare separate **Receipts and Payments Account** in accordance with the Direct Method prescribed in AS 3 – "Cash Flow Statement" issued by the ICAI. Since receipts and payments account has been made a part of financial statements of an insurer, it is implied that the receipts and payments account is also required to be audited. The IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002 require that the auditor of an insurance company should:

i. report whether the receipts and payments account of the insurer is in agreement with the books of account and returns;
ii. Express an opinion as to whether the receipts and payments account has been prepared in accordance with the provisions of the relevant statutes; and
iii. Express an opinion whether the receipts and payments account give a true and fair view

of the receipts and payments of the insurer for the financial year/period under audit.

It may hence be said that auditor is required to audit the Receipts and Payments Account of the insurer and also express an opinion on the same.

12.3 Audit of Accounts

i) Appointment of auditors - The appointment of statutory auditors is made by the C&AG. The appointment of auditors of the agencies abroad is made by the BOD of each company.

ii) Rights and duties of Branch Auditors - The branch auditors appointed to conduct the audit of the divisions have the **same rights and obligations** under the statute as those of the, statutory auditors to whom they are expected to submit their report. ??It is a practice that each divisional office prepares Trial Balance in prescribed format under the Act. Each trial balance, in which are incorporated the figures relating to the branches of the divisions, is required to be audited and the report thereon is furnished to the statutory auditors.

iii) Auditors' Report - The Authority has prescribed the matters to be dealt with by the Auditors' Report vide Regulation 3 under **Schedule C of IRDA** (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000.The Schedule C is reproduced below -

Basic points:

a. Obtained all information which is necessary for the purpose of audit.
b. Proper books of accounts are maintained by the insurer.
c. Proper returns (audited or unaudited) received from branches & other offices.
d. Balance sheet, revenue account, P&L account, R&P account are in agreement with books.
e. Actuarial valuation of liability certified by the appointed Actuary.

Opinion on:

a. Balance sheet gives a true and fair view of affairs of the insurer.
b. Revenue gives a true and fair view of surplus / deficit.
c. P & L gives a true and fair view of profit / loss.
d. R & P gives a true and fair view of receipt / payment.
e. Financial Statement prepared in accordance with regulations of the IRDA, 1999.
f. Investment has been valued as per Act & regulations.
g. Accounting policies appropriate.

He has to Further Certify that:

a. Reviewed management report and no mistake therein.
b. Insurer complied with terms of registration stipulated by the authority.

Certificate that:

a. Verified cash balance and securities relating to insurer's loans & investments.
b. Extent of verification of investment etc., relating to any trust undertaken by insurer as trustee.
c. No part of asset of the policyholder has been applied in contravention of the Act.

iv) Direction of CAG –

a. The C&AG has the **power to direct the manner** in which the accounts shall be audited and give such instructions in regard to any matter relating to performance of functions by the auditor
b. Conduct the **supplementary or test audit** of the accounts of such companies by such person or persons as may be authorised in this behalf.
c. For the purposes of such audit the C & AG may require **information or additional information on such matters** and in such form as may be directed by him in terms of Section 619 (4) of the Companies Act, 1956.

d. The statutory auditors are required to submit a copy of their report to the CAG who has the right to **comment** upon or supplement the audit report.
e. By virtue of the powers vested in him under Section 619(3) (a) of the Companies Act, 1956 the C & AG has recently directed that a **supplementary report** be made by the auditors appointed under Section 619 (2) of the said Act in case of companies carrying on general insurance business. The said report would be on matters listed in the **Appendix** to this unit of the study.

v) Tax Audit – It is necessary for GIC to get their accounts audited u/s 44AB.

vi) CARO – Not Applicable to Insurance Companies.

12.4 Specific Control Procedures (Internal Control) Related To GIC:
The internal controls in the main operations of a **GIC** are discussed below -
i) Underwriting operation - The underwriting function involves the **examination and evaluation** of applications for insurance, the **rating of risks** and establishment of premiums. The internal controls for this operation may be
a. Appropriate and clear **underwriting guidelines** are framed and communicated to the underwriting department and the intermediaries.
b. Establishment of firm **procedures for investigation** of risk assumed.
c. Effective **communication** between underwriting and claims department
d. Periodic review and analysis of suspense and un-reconciled accounts.
e. Establishment of **guidelines for reinsurance** and ensuring their observance.
f. Development of **systems to identify** & quantify premium deficiency on a periodic basis.

ii) Premium - Premium is the **consideration** for risk assumed. The control system in this area is discussed below -
a. The system ensures **calculation** of correct premiums and **collection** of the same before assumption of the risk.
b. Proper **appropriation of premium income** over time periods.
c. Ensuring the **booking of premium** transactions in a timely manner.
d. Proper **control** over insurance policy forms.
e. Maintenance and **periodic reconciliation** of various records like premium register, general ledger, and cash receipts etc.
f. Suspense account balances are reviewed on a timely basis.
g. In case of **renewal premiums**, premium adjustments are properly authorized.
h. Established **procedures to ensure lapsing** and reinstatement of insurance policies.
i The application system should be able to **identify and report erroneous inputs** and processing of policy transactions by unauthorized personnel.
j. A **monetary threshold** is established for which premium input is checked by another person.
k. Each **reversal entry** is properly authorized
l. Management **reviews of revenue accounts** are carried out on a periodic basis.
m There are adequate **cutoff date procedures**.

iii) Commission - Commission is the **consideration payable** for getting the insurance business. The internal controls in this area are aimed to ensure that commission is paid in accordance with rules and regulations of the company, terms of the agreement and legal requirements. The internal controls with regard to commission may include:
a. Established **guidelines** for determining appropriate terms for agency contracts.
b. Appropriate **guidelines** for calculation of commission.
c. Appropriate system is put in place to ensure **timely processing of commission** and regular reconciliation of general ledger and premium register.

d. Commission payments are made in accordance with established guidelines.

iv) Reinsurance - The internal controls with regard to reinsurance may be
a. adequate **guidelines and procedures** are established with respect to obtaining reinsurance and selecting reinsurers.
b. The adequate **procedures** are designed **to notify reinsurers** in time in respect of the losses.
c. Periodic reconciliation of premium ceded register, ceded commission and general ledger.
d. Foreign currency exposures are correctly evaluated.

v) Claims
a. Established procedures for proper **processing and payment** of claims.
b. Adequate procedures to identify and investigate **suspicious claims**.
c. Laying down procedures to ensure proper **recovery of salvage value** of assets.
d. Regular **reconciliation of unpaid claims** and general ledger and statistical data.
e. Monetary thresholds are established for review of claims paid by senior officer.
f. Significant **variances** between **expected and actual** claims are identified and investigated.
g. Suspense account is reviewed periodically.
h. Reinsurance claims if any are duly lodged with the re-insurer.
i. All **settled cases** are recorded as closed in a timely manner.
j. There are adequate **cutoff date procedures**.
k. Specialists like actuaries; lawyers etc. are **consulted** where circumstances require.
l. Effect of **foreign currency fluctuations** is properly accounted.

vi) Investments
a. Adequate and appropriate **procedures for acquisition and disposition** of investments are established.
b. Appropriate **investment strategy** is devised and adhered to.
c. Proper care is taken for **physical custody** of investment certificates.
d. In case **third party holds** investment certificates, proper control on records and transactions should be exercised.
e. The valuation is in accordance with accepted **valuation norms**.

vii) Management Expenses - The following internal control measures may be adopted for management expenses
a. Clear **management guidelines** are issued to cover authorization level of employees / managers for ordering products and services.
b. Authorized personnel receive products and services only.
c. Purchases should be made only from **approved vendors** who should be selected on the basis of tenders received from them.
d. The management who should also enquire into **unusual costs** should regularly review work processes and operating expenses.
e. Authorized personnel should **release payments** only.
f. The company's **policy on travel** and entertainment **expenses** should be clearly laid out and communicated.
g. A **proper system** should be established for compilation of employee records, computation of wage bills and disbursement of the same.

12.5 Audit Procedures Relating To P&L Items: Both premiums and claims have a significant impact on the insurance companies' revenues. It would be an important part of the duty of the auditor to satisfy him that the financial transactions involving both these

operations have been fairly and properly recorded in the relevant books of account. The auditor should also ensure that the legal requirements as to the disclosure of **these items** are complied with in the financial statements:

i) Verification of Premium:

a. The premium collections should be credited to separate Bank account.
b. No Risk shall be assumed by the insurer without receipt of premium.
c. The premium normally arises out of **three sources** – • for direct business, • for re-insurance business and • Share of co insurance premium.
d. Some portion of premium is allocable to succeeding period, thus called unearned premium. Check Reserve for unexpired risk.
e. Cover notes should be serially numbered.
f. Internal controls and procedures w.r.t. premium should be operating effectively.
g. Company should not assume any risk for uncollected premium, short premium, not collected in time, etc.
h. Verify the collection after B/S date, whether it pertains to risks commencing for the yearend audit.
i. Auditor should obtain a reasonable assurance that the company's share of premium has been shown as income and accounts of other companies have been credited for the same.
j. Check whether premium register has been kept chronologically i.e. in order of time of premium received, and Service Tax has been charged on a day to day basis.
k. Due date and date of collection of installments should be reconciled.
l. Year end transactions should be taken care of.
m. Refund of premium (whether made in genuine cases only).

ii) Verification Of Claims

a. Check whether provision has been made for all unsettled claims.
b. Provision has been made only for those for which company is legally liable.
c. Provision made should not exceed insured amount.
d. In determining the amount of provision, Event after B/S date should be considered.
e. Whether 'Average Clause' has been applied, in determining the amount of provision.
f. In case of co**-**insurance, provision only for its share of anticipated liability.
g. Reasons for long delays after claim lodged to be ascertained.
h. Provision made or not for the claim under litigation.
i. Check whether claims are provided for net of salvage value.
j. No contingent liability w.r.t. claim intimated in respect of policies issued.
k. Intimation of loss should be received within reasonable time.
l. Claim paid duly sanctioned by the authority concerned.
m. Claim paid for its share in co-insurance.
n. Claim paid after salvage accounted for.
o. Claim paid, discharge note from claimant.

iii) Commission

a. Commission should be paid only to authorized agents
b. Examine internal controls over payment of commission.
c. Examine whether it has been paid as per appropriate rate.
d. Obtain confirmation from the agents.
e. Examine accounting treatment of outstanding commission, if any.
f. Obtain management representation that all commission has been appropriately adjusted in the accounts.
g. Correlate with this year's business.
h. Check whether TDS has been properly deducted on payment of commission.
i. Verify that no commission is given to agents for businesses directly procured by it.

iv) Operating Expenses Related to Insurance Business - All administrative expenses relating to insurance business should be mentioned in schedule 4 to the financial statement. The **Insurance Act** requires that
a. Expenses in excess of Rs. **5 Lacs or 1% of net premium**, whichever is **higher**, should be shown separately; and
b. Expenses not directly relating to insurance business should be **shown separately** for example, expenses relating to investment department, bank charges etc.

12.6 Audit Procedures Relating To Balance Sheet Items:

i) Investments - The auditor should keep in mind the **following provisions** of the Insurance Act, 1938 while examining the investments-of an insurance company.
a. An insurance company can only invest in **approved securities**. However, it can invest otherwise than in approved securities if the following **conditions** are satisfied.
• Such investments should **not exceed 25%** of the total investments; and
• Such investments are made with the **consent** of board of directors.
b. An insurer should not invest in shares or debentures of insurance or investment company in excess of **least of the following:**
• **10%** of its **own** total assets;
• **2%** of the **investee's** subscribed share capital or debentures.
c. An insurer company should not invest in shares or debentures of a company other than insurance or investment company in **excess of least** of the following
• **10%** of its **own** total assets;
• **10%** of **investee's** subscribed share capital or debentures.
In case the insurance company has invested in **partly paid up shares** of a company, the uncalled liability on the shares is to be added to the amount of invested for the purposes of computing percentages referred to in (**b**) and (**c**).
d. An insurance company **cannot invest** in shares and debentures of a **private company**.
e. The insurance companies **cannot invest** the funds of its policy holders **outside India**.
The authority in exercise of its powers has issued **detailed guidelines** for investment by insurance companies.
Valuation of Investments - AS 13, "Accounting for Investments", do not apply to insurance companies. The salient features of **valuation guidelines** laid down for insurance companies are discussed as follows:
a. Real Estate Investment Property - Such investments should be **valued at historical cost** less accumulated depreciation and impairment loss. The residual value of investment property is considered as **zero** no revaluation of the property is permitted.
b. Debt Securities - Debt securities including Government Securities and Redeemable Preference Shares are required to be considered as **'held till maturity'** securities and shall be measured at **historical cost**. If historical cost is more than the face value, the premium should be amortized over the period remaining to maturity.
c. Equity securities and derivate instruments traded in active markets - The equity securities and derivative instruments that are listed are required to be measured at the **fair value** at the balance sheet date. "**Fair value**" has been defined as the **last quoted closing price** at the stock exchange where the security is listed. Any impairment loss should be charged to profit and loss account. Unrealized gains or loss should be taken to equity under the head '**fair value change account'**. The profit on sale of such securities is determined after taking into account the amounts pertaining to the security sold already credited or debited to equity under the head "fair value change account". This profit or loss is transferred to Profit and Loss Account. Any credit balance in Fair Value Change Account will not be available for distribution as dividends. Also any debit balance in such an account shall be reduced from profits / free reserves while declaring dividends.
d. Unlisted and other actively traded securities - Unlisted and other actively traded securities and derivative instruments should be **valued at historical cost**. Provision for

diminution in value should be made. If estimates based on external evidence show an increase in value of investments over its carrying amount such provision should be reversed.

Audit Procedures - The auditor's **primary objective** in audit of investments is to satisfy himself as to their existence and valuation. He should also examine the **compliance** with regulatory requirements and study the impact of non-compliances. The auditor should:
a. Physically verify the securities on the balance sheet date or a date as near as possible. He should prepare a reconciliation statement where verification is carried out on date other than balance sheet date.
b. Obtain **separate lists of securities** held physically and those held in demat form.
c. Examine the **records for investments** held at branches and request the respective branch auditors to issue a certificate to this effect.
d. Examine in detail investments on which **income has not been received** for a long period and those which have not been redeemed even after redemption date. He should consider the creation of provision of these investments.
e. Where **certificates are held by other persons** such as nominees, share transfer agents etc, the auditor should obtain written certificates from such person. The receipt originally issued by such person Is not adequate for the purposes of audit.
f. Examine that the **norms relating to valuation and disclosure** in financial statements have been complied with. He should examine their accounting policies in this area and the financial impact of changes in such policies.
g. Examine whether **income from investments** is properly accounted for
h. Ensure that **TDS certificates** are properly maintained.

ii) Cash and Bank Balances - The auditor should apply the following audit procedures for verification of cash -
a. The auditor should **physically verify** cash balances at the year end. If it is not possible to verify cash on balance sheet date, proper reconciliation should be drawn between the date of verification and balance sheet data.
b. The cheques received but not deposited in bank should be shown as **cheques in hand**.
c. He should **test check** the bank transactions.
d. He should **obtain confirmation** of the year end bank balance.
e. He may trace the **subsequent realization** of items appearing in bank reconciliation statement and amounts shown as being in transit.

iii) Outstanding Premium & Agents' Balance - The audit procedures, which may be followed with regard to agent's balance, are as follows:
a. Verify whether agent's balances and outstanding balances in outstanding premium account have been **listed, analysed and reconciled** for the purposes of audit.
b. Verify whether **recoveries of large outstanding** have been made in post audit period.
c. Verify whether there is any **old outstanding** debit or credit balances as at the yearend which require adjustment. A written explanation may be obtained from the management is to their nature.
d. Verify that agent's balances do **not include** employees' balances and balances of other insurance companies.
e. Verify that **no credit of commission** is given to agents for businesses directly procured by it.
f. Vouch adjustments / payments against old outstanding balances in agents account.
g. Ensure that the **relevant control account** in the General Ledger is reconciled with the subsidiary records.

iv) Provision for Taxation - The procedures to be adopted by the auditor while auditing provision for taxation are given below -
a. The auditor should check whether provision for taxation has been made after taking into account the **specific provisions** relating to general insurance companies.
b. The auditor should in addition to financial statements **examine other accounts** furnished by the company to the C & AG.
c. The auditor should examine the **income of foreign branches** and foreign countries and the impact of double taxation avoidance treaties.
d. The auditor should see that all **TDS certificates** have been kept and deduction on the same is claimed.
e. The auditor should assess the **implications of wealth Tax Act**, 1957 on the company.
f. The auditor should see the **system of service tax collection** and the payments to statutory authorities and filing of returns.
g. The auditor should **examine sale tax implications** on sale of salvage.

v) Unexpired Risk Reserve - Not all risk expires as on B/S date. Risk will be there in succeeding year w.r.t. premium received in this year; thus provide for —
a. 50% of all other types and
b. 100% for marine Hull.
% is to be taken of net premium income i.e. premium received, net of reinsurance premium paid. Further, the provisions of section 44 of the Income Tax Act, 1961, govern Insurance companies. In this regard, the IT Rules provide for creation of a reserve for un-expired risks. Thus deduction of these reserves is also allowed under the Income Tax Act;

vi) Catastrophe Reserve - Every insurance company carrying on general insurance business is required to create a 'Catastrophe Reserve' to **meet future potential liabilities** against insurance policies in force. Catastrophe Reserve cannot be created for a specific purpose. The auditor should, depending upon the facts of the case **evaluate the adequacy** of such a reserve.

12.7 Reinsurance - The arrangement whereby one insurer obtains insurance from another insurer on risks assumed by the former is called reinsurance. The former is called the ceding company which the latter is called the reinsurer.
i) Types of Reinsurance Contracts
a. Facultative Reinsurance: Reinsurance whereby **separate contracts** are entered into for **each particular risk**. This type of reinsurance is used either when risks are not covered under treaties or the issuer does not want to cover the risk under the treaty etc.
b. Treaty Reinsurance: Where a treaty has been entered into between the ceding company and the reinsurer for reinsurance of particular risks covered under the treaty, it is called as treaty reinsurance.
• **Proportional Treaty:** Such treaties are based on pro-rata apportionment of the sum insured, premium and losses according to a **predetermined ratio**. These treaties can be classified into
~ **Quota Share Treaty:** Under this treaty, the ceding company agrees to cede a **fix %age** on all policies issued by it under a defined scope of business covered by the agreement.
~ **Surplus Treaty:** Under this treaty, the ceding company identifies **excess liabilities** under insurance cover and obtains reinsurance.
~ **Auto for Treaty:** Under this treaty, the ceding company can reinsure up to **specified limits** over and above the limits under surplus treaty.
~ **Pools:** Here members cede a **pre-determined portion** of a particular category of business directly written by them. They pool the premiums as well as the claims
• **Non-proportional Treaties:** Non-proportional Treaties are characterized by **sharing of liabilities** between the ceding company and the re-insurer on the basis of the loss rather

than sum insured. They can be classified into
~ Excess Loss Treaties: Under this type of treaty, the liability of insurer arises only when claims exceed a **predetermined amount** specified for the branches or entire business of the ceding company.
~ Stop Loss treaties: Under this type of treaty, the ceding company is **covered from losing more than specified amount** for a specified class of business.

ii) Verification of Reinsurance Inwards –
a. Obtain evidences as to **effectiveness of system of control** over reinsurance inwards.
b. The agreement should be as per **guidelines** prescribed in the Insurance Act & IRDA.
c. The auditor should examine the **arrangements** with principal insurer.
d. The auditor should ensure the appropriateness of **accounting treatment of reinsurance business** received, premium received and payment of commission.
e. He should examine whether **intimation of loss** has been received well in time.
f. It is also be verified that **claim** as been **paid** as per the **terms and conditions**.
g. Principal insurer being in foreign country, he should examine considering **AS 11**.
h. Check whether **provision** has been made for all claims payable to principal insurer.
i. He should carefully examine any **old outstanding**.
j. Balance confirmation should also be obtained from principal insurer.

iii) Verification of Reinsurance Outward
a. Obtain evidences as to effectiveness of **system of control** over reinsurance outwards.
b. The agreement should be as per **guidelines** prescribed in Insurance Act and IRDA.
c. The auditor should examine the **arrangements with re-insurers**.
d. The auditor should ensure the **appropriateness of accounting treatment** of reinsurance business given, premium paid to reinsurer and receipt of commission.
e. He should examine whether **intimation of loss** has been given to them well in time.
f. It is also be verified that claim has been received as per terms and conditions.
g. If reinsurer being in foreign country, he should examine it considering the **AS 11**.
h. He should carefully examine any **old outstanding**.
i. Balance confirmation should also be obtained from **reinsurer**.

12.8 Co-Insurance
i) In case of **high business risks**, these are **shared** among more than one insurance co.
ii) In case of **coinsurance**, the **leading insurer issues the documents**, collects premiums and settles claims.
iii) The leader renders **statements of Accountants** to the co-insurers.
iv) The auditor should check whether the **premium account** is credited on the basis of statements revived from the leading insurer.
v) Auditor should obtain a **written confirmation** from management that all premium received from leader has been accounted for.
vi) The **claims provisions** and claims **paid** should also be verified.
vii) It should be ensured that **claim is paid** only for its **share** in coinsurance.
viii) For leader, the auditor should examine the relevant **documents.**

12.9 Directions under Section 619 (3)(a) of the Companies Act, 1956 in respect of System of Accounts:
i) Examine the following systems and give your views as regards their deficiencies along with suggestions for remedial measures:-
a. Recording of receipts and expenditure.
b. Drawing periodical trial balance.
c. Compilation of accounts.
d. Reconciliation of inter-office accounts.

e. Reconciliation of registers/records relating to property, assets. Investments, premiums, claims, loans, etc., with financial books.
f. Maintenance of up-to-date records in respect of assets, which are pledged, encumbered or blocked in any way.
ii) Are the bank accounts of the company reconciled with the bank statements regularly? If not, describe the failures.
iii) Are control accounts and subsidiary accounts up-to-date and reconciled regularly? If not, describe the failures.
iv) Examine the accounting policies of the company. Are these in conformity with the AS. Give particulars of material departures from these standards, if any, along with their effect on FS; quantify the impact wherever possible.

CASE STUDIES

Q1. "In an audit of an Insurance company, the Receipts and Payments Account is also subjected to audit". Comment on this statement in brief.
Hint Ans: Refer Point 12.2 (ii-e).

Q2. Write short notes on Solvency Margin in case of an insurer carrying on General Insurance Business.
Hint Ans: Refer Point 12.2 (ii-d).

Q3. "Verification of premium is of utmost importance to an auditor in the audit of General Insurance Company". What are the steps to be taken by an auditor while verifying the premium?
Hint Ans: Refer to Point No. 12.5 (i).

Q4. As per the directions under Section 619(3)(A) of the Companies Act, 1956 applicable to Insurance Companies, which are the points on which the Statutory Auditor has to report on in respect of System of Accounts?
Hint Ans: Refer to Point No. 12.9.

Q5. Enumerate the steps to be taken by an auditor for the verification of Re-insurance outward by a General Insurance Company.
Hint Ans: Refer to Point No. 12.7 (iii).

Q6. The management of Safe Insurance Ltd is not sure about the matters that need to be disclosed under contingent liabilities in its FS. As the CFO of the company, guide the management as to what needs to be disclosed under this head.
Hint Ans: Refer to Point No. 12.2 (ii-b).

QUESTIONS

Q1. As the auditor of an Insurance company state the audit procedure you would follow to verify outstanding premium and agents balances. (4 Marks) **(Nov 2008 & 2010)**

Q2. While auditing the claims paid in respect of a General Insurance Company what aspects need to be looked into? (6 Marks) **(May 2010)**

Q3. State the disclosure requirements in respect of contingent liabilities in the notes to the B/S of a General Insurance Company. (4 Marks) **(May 2011)**

13. AUDIT OF CO-OPERATIVE SOCIETIES

13.1 Special Points for Audit of Co-Operative Societies

i) Qualifications of Auditors - **CA** or some of the State Co-operative Acts have permitted persons holding a **government diploma in co-operative accounts** or in co-operation and accountancy as also a person who has served as an auditor in the co-operative department of a government to act as an auditor.

ii) Appointment of auditors - An auditor of a co-operative society is appointed by **Registrar** of cooperative societies and he reports to the Registrar as well as the society. The audit fees are prescribed on the basis of scale of the co-operative society.

iii) Books, Accounts and other records of Co-operative Societies - Under section 43(h) of the Cooperative Societies Act, a **state government** can frame **rules** prescribing the books and accounts to be kept by a co-operative society.
a) Property and Investment Register - The register should give details regarding **brief description of assets** such as situation, make, date of acquisition, cost price, depreciation provided up-to-date etc.
b) Fixed Deposits Register - In case of Urban Co-operative Banks and credit societies accepting deposits from members, a fixed deposit register should be maintained showing all **particulars** such as date of acceptance, date of maturity, interest due date, repayment etc.
c) Surety Register - In case of co-operative credit societies, loans are given against the personal security of the debtor, in addition to a surety or guarantee given by two members.

iv) Restrictions on Share holdings - In case of societies with limited liabilities, a member other than registered societies can hold shares only to the extent of least of the two:
a. 20% of the total number of shares;
b. shares of the value of Rs. **1000.**

v) Restrictions on loans - A registered society shall not make loans to persons **other than its members**. However, by passing **a special resolution**, loans can be given to another registered society.

vi) Restriction on borrowings – The auditor should verify that borrowings of a registered society are within the **limits laid down** for them.

vii) Investment of funds - A Co-operative society can invest in one or more of following:
a. Central or state co-operative bank
b. Securities specified in the Indian Trust Act, 1882
c. In the shares, securities, bonds or debentures of any other society with limited liability.
d. In co-operative banks other than those mentioned above, as approved by the registrar.
e. In any other moneys as permitted by CG or SG.

viii) Investment of Reserve fund outside the business or utilization as working capital - The auditor should ensure that reserve fund balances have been utilized as per **rules and regulations** governing the society.

ix) Contribution to Education Fund - Some state Acts require that every society should create education fund **by creating a charge on profits**. The auditor should ensure compliance of these requirements.

x) Contribution to Education Fund - Some of the State Acts provide that every society shall **contribute annually** towards the Education Fund of the State Federal Society, at the

appropriate rate as per the class of the society. Contribution to Education Fund is a **charge** on profits and not an appropriation.

13.2 Special Features Of Audit

i) Examination of overdue debts - Overdue debts for a period from six months to five years & more than five years will have to be **classified** and have to be reported by auditor. Auditor will have to ascertain whether **proper provisions** for doubtful debts are made.

ii) Overdue Interest - Overdue interest is interest accrued or accruing in respect of which the principle sum is overdue. Such interest should be **excluded** while **calculating profits.**

iii) Valuation of Assets and Liabilities - The auditor will have to examine **existence, ownership and valuation** of assets. Fixed assets should be valued at cost less provision for depreciation. The current assets should be valued at cost or market price, whichever is lower. All the known liabilities should be brought into the account.

iv) Adherence to co-operative principles - Check how far the sales could be affected at lower prices. While auditing expenses auditor should see that they are economically incurred and there is no wastage of funds. The principles of **propriety audit** should be followed.

v) Observations of the Provisions of the Act and Rules - The **financial implications** of such infringements should be properly assessed by auditor and they should be reported.

vi) Certification of Bad Debts - A peculiar feature regarding the writing off of the bad debts is that bad debts can be written off only when they are certified as bad **by the auditor or managing committee.**

vii) Verification of member's Register and examination of their pass books - The auditor should verify the entries in members pass book regarding **loan given and its repayments and confirmation of balances.**

viii) Special Report to the Registrar - If the auditor notices that there are **some serious irregularities** in the working of the society he may report these special matters to the Registrar. The Registrar on receipt of such a special report may take necessary **action** against the society. In the following cases, a special report may become necessary:
a. Personal profiteering by members of managing committee.
b. Detection of **fraud**
c. Examples of **mismanagement Decisions** of management against cooperative principles.
d. In urban co-operative bank, **disproportionate advances** to vested interest group.
e. Reckless advancing without judging the credit worthiness of the party.

ix) Audit classification of the society - If the management of the society is **not satisfied** about the award of audit class, it can make an **appeal** to the **Registrar,** and the Registrar may direct to review the audit classification. The auditor should be very careful, while making a decision about the class of society.

x) Discussion of draft audit report with managing committee - The audit report should never be finalized without discussion with managing committee. Minor irregularities may be got settled and rectified. Matters of policy should be discussed in detail.

13.3 Appropriation/Distribution of profits – A co-operative society has to transfer
i) at least 25% of profit should be transferred to Reserve Fund before distribution.

ii) In case the financial position of the society does not permit such transfer, **Registrar** may reduce it but **at least 10%** is even then required.

13.4 Audit Report

i) On completion of audit, auditor has to issue his report in the **form specified** by registrar**.**
ii) Along with this report, the auditor has to **attach schedules** to report the following:
a. Transactions **contrary to the provisions** of the act, rules or bye laws of the society.
b. All **sums**, which ought to have been, but have **not been brought** into account.
c. Any **material,** or property which appears to the auditor to be **bad or doubtful.**
d. Any **material irregularity** or impropriety in expenditure or in realization of monies due.
e. Any **other matter** specified by the registrar in this behalf.

13.5 Rights And Duties Of Co-Operative Auditors

i) The **Registrar** shall audit or cause to be audited by some person **authorized by him** by general or special order in writing in this behalf the accounts of every registered society once at least in every year.
ii) The auditor shall have **access to all the books**, accounts, papers and securities.
iii) Every officer of the society shall **furnish** such information in regard to the transactions and working of the society as the person making such inspection may require.
iv) The auditor has to **submit his audit report** to the society, and copies thereof to the respective authorities such as District Special Auditor, District Deputy Registrar etc.
v) The audit report has to be submitted in the **prescribed form** specified by the Registrar or as given in the related Rules.

13.6 Audit, Inquiry And Inspection Of Multi-State Co-Operative Societies (MSCS)

The Multi-State Co-operative Societies Act, 2002, which came into force in August, 2002 applies to cooperative societies whose objects are not confined to one State.

i) Audit of Multi-State Co-operative Society –

a. Qualification of Auditors (Sec 72) - A person who is a CA. However the following persons are **not eligible** for appointed as auditors of a Multi-State cooperative society:
•A **body corporate**
• An **officer or employee** of the Multi-State co-operative society
• A person who is a **member or** who is in the **employment**, of an officer or employee of the Multi-state co-operative society.
• A person who is **indebted** to the Multi-State co-operative society or who has given any **guarantee** or provided any security in connection with the indebtedness of any third person to the Multi-State co-operative society for an amount exceeding Rs. 1000.
If an auditor becomes subject, after his appointment, to any, of the disqualifications specified above, he shall be **deemed to have vacated** his office as such.

b. Appointment of Auditors (Sec. 70) –
• **First auditor** by **board within one month of registration** date to hold office until conclusion of 1st AGM. If board fails to appoint, then in general meeting.
• **Subsequent auditor at each AGM.** He shall hold office from **conclusion** of that meeting until conclusion of next AGM.

c. Power and duties of the Auditor in relation to Audit of a MSCS - Right to access at all times to books, Accounts & Vouchers, to require information & explanation from employee / officers, to attend GM, to send representation on removal.
Following inquiries shall be made [73 (2)]
• **Loans and advances** made on the basis of security have been properly **secured** and the terms on which they have been made are not prejudicial to interests of Society or its Members,

• Transactions of the Society represented merely by **book entries** are not prejudicial to its interests,
• **Personal expenses** have been charged to Revenue Account, and
• **Cash** has been received in respect of **shares allotted** for cash, and if no cash has actually been so received, whether position as stated in the account books and B/S is correct, regular and not misleading.

d. Special Schedules (Rule 27) - The Audit Report shall also contain schedules with particulars of -
• All **transactions** which appear to be **contrary** to the provisions of the Act, Rules or Bye-laws of the MSCS,
• All transactions which appear to be **contrary to the guidelines** issued by RBI and National Agriculture and Rural Development Bank,
• Any money belonging to the MSCS which appears to the Auditor to be **bad or doubtful** of recovery,
• The **loans given** by the MSCS to the **members** of the Board,
• Any **violation of guidelines, conditions** etc. issued by RBI or National Agriculture and Rural Development Bank, by any Co-operative Bank,
• Any **other matter** as specified by the Central Registrar in this regard.

13.7 Power Of Central Government To Direct Special Audit In Certain Areas

i) In case, **CG** or **SG** either alone or both **hold 51% or more** of paid-up share capital In such MSCOS.
ii) Central Government may direct either a **C.A or MSCOS's auditor** to conduct special audit & make a report to it.
iii) If Central Government is of opinion that:
a. Affairs of MSCOS **aren't** being **managed** in accordance with **self help** & Cooperative principles or sound business principles or:
b. MSCOS is managed in manner likely to cause serious injury/**damage to interest of trade/**industry or business to which it pertains or
c. The **financial position** of any MSCOS is such as to endanger its **solvency**,
iv) Auditor has **same powers & duties** as in Sec. 73.
v) On receipt of report of special audit, CG may take **such action** as it considers necessary.

13.8 Inquiry & Inspection By Central Registrar Under Section 79

i) Central Registrar may on request from
a. Federal co-operative to which MSCOS is affiliated or
b. A creditor or
c. At least 1/3 of member of board or
d. At least *1/5* of total member of MSCOS
Holds an enquiry or directs some person to enquire into constitutions, working & financial condition of MSCOS. However, before inquiry, 15 days notice is to be given to MSCOS.
ii) Central Registrar or person authorized shall have following powers:
a. Free access to books / A/c **/** Cash **/** Properties in custody of MSCOS in event of serious irregularity, take them into custody.
b. Summon any person to produce the books etc. as above.
c. Require the officer to **call GM** by giving notice of at least 7 days or if officers fail **/** refuses, he may call it himself.
d. Summon any person having knowledge to appear before him & examine him on oath.
iii) Central Registrar within **3 months** of receipt of report **communicates the report** of enquiry to society, Financial Institution & to person at whose instance it is needed.

CASE STUDIES

Q1. A major part of the business of Cooperative Housing Society is to avail loans from Housing Finance Corporation and in turn give loans and advances to its members for construction of houses indicate any eight (8) points that will receive your attention as auditor of the Cooperative Housing Society.
Hint Ans: The auditor should see the following important aspects:
i. Examine the **agreement** of loan with Housing Finance Corporation
ii. Obtain a **list of members** to whom loans are granted with a schedule of recoveries. Check the recoveries of loans from members with receipts issued. Also ascertain whether the allocation between principal and interest is properly accounted for.
iii. Check the **repayment of loan** installments with the receipts from Housing Finance Corporation.
iv. Verify **investment in shares** of Housing Financing Corporation by the Society
v. Ascertain that the **dividends** on above shares are collected by the society
vi. Examine the **personal ledger balances** of members relating to loan accounts and see that balance **confirmation certificates** is obtained from members. Also obtain a balance confirmation certificate from Housing Finance Corporation.
vii. Check whether a **proper schedule** is prepared by the society.
viii. Verify **declaration from members** creating charge in favour of the society and the insurance policy has been obtained by the society in report of the total amount of loan.

Q2. Write note on Special Report by auditor to Registrar of Cooperative Societies.
Hint Ans: Refer to Point No. 13.2-vii

Q3. "The general process of auditing and the process of audit of Co-operative Societies are same but there are some special features to be kept in mind while doing audit of co-operative societies. What are the special features of Co-operative Societies Audit?
Hint Ans: Refer to Point No. 13.2

QUESTIONS

Q1. List special features involved in audit of a Cooperative Society. (8 Marks) **(June 2009)**

Q2. Under what circumstances, an auditor is required to submit a special report to the registrar of Co-operative Societies? (4 Marks) **(Nov 2009)**

Q3. "Examination of overdue debts, audit classification of society, and reporting the infringement of provisions of the Act are the special features of audit of a co-operative society." Do you agree? (6 Marks) **(Nov 2010)**

Q4. State the requirements regarding the maintenance of books of accounts with respect to a multi-state co-operative society. (4 Marks) **(May 2011)**

14. AUDIT OF NBFC (NON-BANKING FINANCIAL COMPANIES)

14.1 Classification - NBFCs can be classified into the following categories:
i) Non-Banking Financial Company (NBFC) - NBFC is one whose principal business is that of **receiving deposits or** that **of financial institution.**
a. Equipment Leasing Finance Company
b. Hire Purchase Finance Company
c. Investment Company
d. Loan Company
e. Residuary Non-Banking Company (RNBC) that receives deposits under any scheme.

ii) Mutual Benefit Financial Company (MBFC) (i.e. Nidhi Company) - Company which is **notified by the CG** u/s 620A of the Companies Act, 1956.

iii) Mutual Benefit Company (MBC) (i.e. Potential Nidhi Company) - Company which is working on the lines of a Nidhi Company, but -
a. not yet declared so by the CG,
b. has minimum Net Owned Funds (**NOF**) of Rs.**10 Lakhs**,
c. has **applied to** the **RBI** for Certificate of Registration,
d. has **applied to** Department of Company Affairs (**DCA**) for declaration as Nidhi Co, and
e. has **not contravened** any Directions/Regulations of RBI /DCA.

iv) Miscellaneous Non-Banking Company (MNBC) (i.e. Chit Fund Company)
a. These Companies **manage,** conduct or supervise **as a Promoter**, Foreman or Agent of any transaction / arrangement.
b. They enter into an **agreement** with a specified number of subscribers that every one of them shall **subscribe a certain sum** in installments over a definite period.
c. The agreement will provide that every subscribers shall be **entitled to prize amount** determined either - • by lot • by auction • by tender • in such other prescribed manner.

14.2 Audit Procedure
i) General Procedure
a. Ascertaining the **business** of the Company.
b. Evaluation of **Internal Control** System.
c. Registration with RBI which is compulsory for companies having minimum net owned funds (NOF) of Rs.2 crores. Also ascertain whether it has submitted **quarterly return** with RBI about **Liquid Assets within 15 days** in specified form. Moreover, it must transfer **at least 20%** of its net profit to reserve fund before any dividend is declared.

ii) NBFC Public Deposit Directions
a. Public deposit should be in accordance with the **credit rating Deposit** assigned to it.
b. Interest calculations should be proper.
c. NBFC should have accepted public deposit or renewed it only after **written application** is received by the depositor in a specified form.
d. Public deposits should be accepted only after **advertisement** or statement in lieu of advertisement has been filed with RBI.
e. Check **deposit register** (payment on due date).
f. Investment in approved **liquid assets** and it should be kept in safe custody.
g. Audited statements to be submitted within **15 days** of Holding AGM to RBI.
h. Annual Return to be submitted to RBI within **6 months** from close of year.
i. If it is **not accepting** deposits, see **Board resolution** in this behalf.
j. For Group holding Investment Company, see board resolution to identify the group.

iii) NBFC Prudential norms Directions

a. Check compliance with **prudential norms** encompassing, income recognition, income from investment, AS**,** asset classification, capital adequacy norms, prohibition on granting of norms against own shares, prohibition on loans and investment, for failure to repay public deposits etc

b. An auditor should ensure that the Board of Directors of every NBFC granting/intending to grant demand/call loans shall **frame a policy** for the company and shall **implement** too.

c. He should verify that advances and other **credit facilities** have been properly classified as **standard/sub standard/doubtful/loss** and that proper provision has been made.

d. Income from NPAs should be accounted for on **realization basis** only.

e. He should check whether **Previous year's NPA account** has been continue or not.

14.3 Audit Check List

i) Equipment Leasing Finance Company

a. Ascertain whether **proposals** for Leasing are **accepted** only after adequate appraisal.

b. The auditor should verify whether there is an **adequate system** in place for ensuring **installation of assets** and their periodical physical verification.

c. The system for ensuring that the asset is adequately **insured** and properly maintained should be in place.

d. The auditor should ensure that leasing transactions are **classified** and accounted as per **AS- 19** "**Leases**".

e. Ensure that the provisions relating to **asset classification**, provisioning and income recognition laid down for lease financing by NBFCs are observed.

ii) Hire Purchase Finance Company

a. The auditor should verify whether there is a **proper system** in place for adequate **appraisal of proposals**.

b. The auditor should verify that **payments for assets** are made directly to the vendor and the assets are in the name of the company.

c. The auditor should verify whether an **adequate system** is in place to ensure **installation** of the asset and their periodic physical verification.

d. If the hire purchase agreement is against vehicles, the **registration certificate** should contain an endorsement in favour of the financing company.

e. The auditor should verify whether there is adequate system to ensure that **no charges are created** on the assets **by the borrower** with proper approval of the financing company.

f. The auditor should check whether **interest income** is properly **recognized**.

g. The auditor should verify that **hire purchase assets** are adequately **insured**.

h. The auditor should examine the **valuation of goods sold** on hire purchase and goods repossessed.

i. The auditor should ensure that **provisions relating to asset classification**, income recognition and provisioning laid down for hire purchase financing by NBFCs have been observed.

iii) Investment Company

a. The investment **certificates** should be **physically verified**. In case they are lodged with another person; certificate to that effect should be obtained from such institution.

b. Verify whether **investments** made by the NBFC are within **limits laid down** under the NBFC prudential norms.

c. Check that **no loans** have been advanced on the security of its **own share**.

d. Verify that **income** in the form of interest, dividend and capital gains is properly **recognized**.

e. Test Check the **contract notes** received from brokers with the prices in the stock market

on the respective dates.
f. Ensure that there is a proper **system of authorization for purchase and sale** of investments.
g. Check whether **investments** have been **valued** as per NBFC Prudential Norms and AS 13 "Accounting for Investments".
h. Check the **investments made in subsidiary** / group companies for basis for price paid, quantum of investment made etc.
i. Check whether **investments in unquoted debentures** and bonds have not been **classified** as investments but as term loans for the purpose of asset classification, provisioning and income recognition.
j. In case of **securities lent / borrowed** under securities lending scheme of SEBI, verify the **terms and conditions** of the agreement.
k. In respect of shares/securities held through a **depository**, obtain a **confirmation** from the depository regarding the shares/securities held by it on behalf of the NBFC.
l. Verify **charges received or paid** in respect of securities, lend/borrowed;

iv) Loan Company
a. The auditor should verify whether there is system in place for **proper appraisal**, and sanction of loans.
b. The auditor should verify the **terms of sanction** and security obtained.
c. Verify that adequate **records** are maintained as regards the **bill discounting facilities**.
d. Check that the **loans** are within the **limits** specified for single and group borrowers.
e. No loans should be given on the security of NBFCs **own shares**.
f. Check whether norms for **asset classification**, provisioning and income recognition as specified for credit facilities have been adhered to.
g. The auditor may also obtain **balance confirmation** from the borrowers.
h. In case of companies which are engaged in the business of providing **short term funds** in the ICDs market, the auditor should ascertain whether the NBFC has a regular system for ascertaining the **credit worthiness** of the clients prior to placed by the company are being rolled over and whether there is any **risk of non-recovery**.
i. An auditor should also verify whether provision for **bad and doubtful debts** has been **disclosed separately** in the B/S and the same have not been netted off against the income or against the value of assets as required by the NBFC Prudential Norms Directions.

14.4 Auditor's Duty - The Auditors are required to make a **separate report** to the Board of Directors and the RBI for every financial year as per the **Non Banking Companies Auditors' Report (RBI) Direction 1998**, in addition to the reporting obligations u/s 227 of the Companies Act 1956.
i) Reporting Requirements - The auditor shall make a statement on the following matters, together with reasons in case of any unfavorable or qualified statement.
a. Registration - Whether the NBFC has obtained certificate of Registration or applied for registration.
b. Communication from RBI - Whether the NBFC has received any communication from RBI refusing grant of Certificate of Registration.

ii) NBFCs accepting / holding public deposits -
a. Limit on Public Deposits - Whether the public deposits and the following borrowing are within the **permissible limits**.
• Borrowing from public by issue of unsecured Non-convertible Debentures / Bonds.
• Borrowing from its share holders by a public limited company and
• Other deposits within definition of "Public Deposit" in NBFC (Reserve Bank) Direction.
b. Credit Rating - Whether Credit rating for fixed Deposits, assigned by the credit rating agency **is in force**.

c. Limit on Fixed Deposits - Whether **aggregate amount of Deposit outstanding** at any point during the year has exceeded the limit specified by the Credit Rating Agency.
d. Default - Whether NBFC has defaulted in paying to its Depositors the **interest and/or principal amount** of the deposits after such interest and / or principal became due.
e. Prudential Norms - Whether the NBFC has complied with NBFC Prudential Norms (Reserve Bank) Direction, 1998 in relation to Income Recognition, classification, Provisioning for bad and doubtful debts and concentration of Credit / Investment.
f. Capital Adequacy - Whether the capital Adequacy Ratio **disclosed in the return** submitted to the RBI is correctly determined and whether such **ratio** is in compliance with the minimum capital to Risk Asset Ratio prescribed by the RBI.
g. Liquidity - Whether the NBFC has complied with the **prescribed** liquidity requirement and kept the approved securities with designated Bank.
h. Return of Deposits - Whether the NBFC has **furnished** the return of deposits to the RBI **within the stipulated period** as required under First Schedule to NBFC Prudential Norms (Reserve Bank) Directions, 1998.

CASE STUDIES

Q1. Explain the classification of NBFCs. What are the special points in the audit of a Non-Banking Equipment Leasing Finance Company?
Hint Ans: Refer To Point No 14.1 and 14.3-i

QUESTIONS

Q1. You are the auditor of IJK Ltd., a NBFC registered with RBI. How would you proceed to ensure the compliance of Prudential Norms directions by it? (4 Marks) **(Nov 2008)**

Q2. Enumerate the verification procedures in relation to audit of a Hire-Purchase Finance Company. (8 Marks) **(June 2009)**

Q3. Write short notes on the special points that may be covered in the audit of equipment leasing finance company. (4 Marks) **(May 2010)**

15. AUDIT UNDER FISCAL LAWS

15.1 Audit(s) Under The Income Tax Act, 1961 - The IT Act, 1961 (hereinafter referred to as the Act) contains several **provisions** for audit of accounts of public charitable trusts, non-corporate assesses & other assesses to meet the specific objectives of the Act. Under the Act, several sections such as 12A, 35D, 35E, 44AB, 80IA, 80-IAB, 80-IB, 80-IC, 80-ID, 80-IE, 142(2A), etc., **require audit** of accounts **for tax purposes**. We shall discuss the requirements of some of these provisions from the audit angle.

i) Audit of Public Trusts (Sec. 12A) - Public Trust can **claim exemption** u/s 11 & 12 of the IT Act. **Conditions** are:
a. The Person in receipt of the income has made an application for **registration** of the Trust/institute to C.I.T. **before expiry** of one year from date of creation of trust.
b. Where total income is **greater than** exemption limit in any previous year, the accounts of Trust/Institute have been audited.

Audit program

a. Preliminary

- **Obtain resolution** from trust (Scope of audit)
- **Letter** of appointment from Trust and communicate with **previous auditor**.
- Certificate as to **Opening balance** of Assets and Liabilities and Fund.
- List of **Book of Accounts.**
- **Certificate from trust** as to system of accounting and I.C.
- List of **institutions / activities** run by Trust.
- Certified true copy of **deed of Trust**.

b. Routine Checking

- **Check** Book of Accounts.
- **Vouch** transactions. Whether transactions are within **power and authorized**, properly accounted for and funds have been applied towards objects of the trust.
- Obtain Trial Balance on **closing date** certified by trust.
- Obtain **B/S and P&L** A/c **approved** by the trustee.

c. Accounting Principles

- All **assets** properly **valued** and depreciated.
- All **liabilities** properly accounted for.
- **Investment** properly classified and market values are shown.
- **Outstanding** due to trust properly accounted for. Its **recoverability** should be examined. Provisions should have been made for irrecoverable.

d. Annexure to Audit Report

- Certified **list** of person u/s. 13(3).
- **Statement** for items specified in annexure to form 10B.

e. Applicability of Accounting Standards

- AS will **not apply** all activities are not commercial, industrial or business in nature.
- **Even if a small portion** of activities of an entity is commercial, **industrial or** business in nature, AS would apply to **all its** activities including those which are not commercial, industrial or business nature.

ii) Audit u/s 44AB

a. Applicability - Any person get his A/c. audited by an Accountant who -

- Carrying on **Business** total turnover or gross receipt exceeds **1 Crore** rupees.
- Carrying on **Profession**, if gross receipt exceeds **25 lakh** rupees.

• Carrying on Business, if Profit and Gains from Business are **deemed to be Profits** and Gains of such person and if he has claimed his income to be **lower than deemed one.**

b. Applicability of Accounting Standards (Section 145)

• Income under head "Business or Profession" or from "Other Sources" be computed in accordance with either cash mercantile regularly employed by the assessee.
• **C.G.** may notify AS to be followed.
• If **A.O. not satisfied** about correctness or completeness accounts of Assessee or where method of accounting have not been regularly followed by the assessee, he may make assessment as per method provided u/s 144.

AS (IT) mandatory for those following mercantile system:

• AS-1 relating to disclosure of accounting policies.
• AS-2 relating to disclosure of prior period and extraordinary items and changes in accounting policies.

The tax auditor is not computing the income but:

• reporting on accounts and
• reporting on relevant information furnished in form no. 3CD.

Thus in case of non-compliance with AS, the auditor should make appropriate qualification / disclosure in the audit report.

c. Audit Report

• Form 3CA & 3CD for person carrying on Business or profession, who is required under any other law to get his accounts audited; and
• For 3CB & 3CD for others.

d. Accounting Ratios In Form 3CD Of Tax Audit

• Gross Profit / Turnover
• Net Profit / Turnover
• Stock in Trade / Turnover
• Material consumed / finished goods produced.

These ratios have be calculated only for assesses who are engaged in manufacturing or trading activities. This clause is not applicable to assesses carrying on profession. Moreover, the ratios have to be given for the business as a whole and need not be given product wise. Further, the ratio mentioned in sub-clause (d) need not be given for trading concern.

15.2 Auditing Under VAT

i) Meaning

a. VAT is a tax on the **value added** to the commodity at **each stage** in production and distribution chain.
b. VAT is an indirect tax on consumption.
c. The total amount of tax, which is to be **collected** at the final or retail point of sale, is collected in installments.
d. Major states who have introduced VAT have generally **incorporated audit provisions** in their VAT legislation.

ii) Steps

a. Knowledge of Business - The auditor should obtain preliminary knowledge of the industry and of the nature of ownership, management and operation of the entity to be audited. The knowledge of business is important not only to the auditor but also to his staff engaged in the audit.

b. Knowledge about the VAT Law and Allied Laws - The auditor and his staff should obtain a detailed knowledge of the State VAT law under which the audit is to be conducted. The auditor should study the VAT law starting from the definition of various terms, the procedure to be adopted.

c. Ascertaining the Major Accounting Policies Adopted by the client - The auditor should know the major accounting policies based in which, books of accounts have been recorded.
d. Evaluation of internal Control - Before determining the extent of audit checks to be applied, i.e. whether to go in-depth or to do only test check, the auditor should ascertain whether there is an I.C. system in operation in the entity.
e. Obtaining list of all A/c Record Maintained by client - The auditor should obtain a complete list of all the accounting records relating to sales/purchase of goods.

iii) Audit Program
a. The turnover of **sales/purchases** of goods has been properly determined. The sales turnover arrived at by applying the generally accepted accounting policies may not be the same as required under the VAT law.
b. The turnover of **purchases** should be tested to enable the auditor to get the purchases eligible for grant of **input tax credit** segregated from other purchases.
c. The auditor is expected to list out the **due dates of filing of returns** and find out the reasons for delay in filing the returns, if any.
d. The auditor should **apply tests** as will enable him to ascertain whether the auditee is eligible for composition.
e. The auditor may also be expected to **check the consolidation** of the returns filed for all the periods covered in the year under audit.
f. The auditor should check whether **all the transactions** relating to sale and purchase are entered in the books of account and have been taken into consideration while filing the returns.

iv) Audit Report under the Vat Law - At the end of the audit the auditor has to arrive at his conclusion on the matters to be reported in the audit report. The **format** of the audit report is generally prescribed under the relevant VAT law and the auditor has to fill in all the columns of the audit report that are applicable. His **opinion** is on the adequacy of accounting records, correctness and completeness and arithmetical consistency of returns filed.

15.3 Excise Audit 2000

i) For whom

Quantum of annual total duty payment in (in cash + CEN VAT Credit)	Frequency of audit
Units paying more than Rs. 3 crores	Every year
Units paying between Rs. 1 crore and Rs. 3 crores	Once in every two years
Units paying between Rs. 50 lakhs and Rs. 1 crore	Once in every five years
Units paying below Rs. 50 lakhs	10% of the units every year

ii) Steps in Auditing
a. Preliminary review
• The audit team **gathers** as much relevant **information** as possible about the assessee.
• The **details** to be gathered are reason for selection, result of last audit, profile of the assessee giving details of ownership, goods manufactured etc. revenue realized, details of anti-evasion action if any, income tax returns, sales tax returns, annual reports, Cost audit reports etc.
b. Gathering and documenting the information
• It starts as soon as the party reaches the unit.
• The team gathers and documents systems information by **interviewing key personnel**.
• The auditors also find out about trading activity, exports, purchase procedure and policy,

imports and other revenues.

c. Tour of the premises/plant

• This is a very important element of the audit programme.
• The audit party gets an opportunity to physically verify many facts as understood during the first two phases and clarify doubts in this phase.
• The tour should cover all areas and should be thorough.

d. Evaluation of internal controls

• The evaluation of internal controls involves study of tax accounting, revenue accounting and expenditure accounting.
• '**Walkthrough' method** can be a very effective tool in evaluation of internal control.
Risk loss analysis
• Based on the studies made in the earlier steps, the audit party (Reasonableness has to analyze and work out what would be the risk to revenue test) because of deficiencies of accounting system.
• The analysis will be used for development of Audit plan.

e. Trends analysis

• Study of trends in revenue, profit, prices and quantum of the items manufactured over a period will help the audit party in identifying areas which are to be looked into.

f. Development of Audit plan

• After completing all the steps detailed above, the auditors develop an audit plan in a narrative or list format.

g. Verification

• The Audit Programme has detailed guidelines for verification of each and every aspect of the audit work.
• The auditors are expected to use the guidelines and other techniques effectively to achieve best results.

h. Audit Findings

• After completion of the audit, audit findings are to be prepared.
• Every finding should be substantiated with adequate evidence in the relevant Working Papers.

i. Review of results with the assessee

• Findings especially relating to short levies are to be handed over to the assessee and reviewed.
• Wherever the assessee agrees with the findings, he may be persuaded to pay the amount and pay the correct duty in future.
• Where the findings relate to procedural deficiencies, an undertaking will be sought from the assessee about future compliance.

j. Review with the Divisional Asstt Commissioner

• The auditor should also have a discussion with the concerned AC before preparing the final Audit report.
• This will ensure greater accuracy in the report.

k. Finalization of Report

• The final report will contain the details of findings of the auditor.
Excise Audit 2000 is a good and participative audit. Auditor must be thorough about laws and having good accounts background.

iii) Procedure of Excise Audit 2000 - at a glance

a. Selection of Assessee is based on Risk factor. If track record is bad, priority will be high.
b. Gathering information about the assessee without interacting with him.
c. Documenting Information by sending the questionnaire and obtaining responses.
d. Visiting the units of assessee to see the actual running of business.
e. Preparing an Audit Plan to list vulnerable areas, plan should be dynamic.

f. Verification of actual audit on a scheduled date.
g. Audit objection and Audit Para if short/nonpayment. Discuss with assessee.
h. Making an Audit Report by way of drafting. Discussing with senior officers. Then finalizing it

CASE STUDY

Q1. As a tax auditor, how would you report on the following:
a. Labour charges paid on which tax deducted at source at an inappropriate rate.
b. Capital expenditure incurred for Scientific Research Assets.
Hint Ans: a. If tax is deducted at an inappropriate rate, the amount is disallowable under section 40(a)(ia) of the Income-tax Act. This fact needs to be reported in Form 3CD where all amounts inadmissible under section 40(a) are to be reported.
b. Clauses 15 of Form 3CD requires to report the expenditure on Scientific Research (capital as well as revenue) covered under section 35 of the IT Act, 1961. Accordingly, the auditor should report the amount of capital expenditure not debited to the P/L a/c which is eligible for deduction u/s 25 as Scientific Research Expenditure.

Q2: Discuss the reporting requirements in Form 3CD of the Tax Audit Report U/S 44AB of the Income-tax Act, 1961 for the following:
a. Tax on distributed profits.
b. Brought forward loss or depreciation allowance. (NOV 2009 OLD)
Hint Ans: a. The tax auditor has to report on profit distributed during the FY and therefore the amount of tax paid on such distributed profit at the prescribed rate plus surcharge at the applicable rate on tax and education cess thereon, the dates of payment with amount, has to be reported.
b. The manner of reporting:

S.No.	Assessment Year	Nature of loss/allowance (in rupees)	Amount as returned (in rupees)	Amount as assessed (in rupees)	Remark

For giving the above information, the auditors should verify the assessment records i.e., • Income tax return filed. • Assessment orders • Appellate orders • Rectification/revision orders of the earlier years and ascertain if the figures given in the above clause are correct.

Q3. Write an audit programme for the audit of public trust u/s 12A of the IT Act, 1961?
Hint Ans: Refer to Point No. 15.1 (i)

Q4. Mr. X, who conducts the tax audit u/s 44AB of the IT Act, 1961 of M/s ABC, a partnership firm has received the entire audit fees of Rs. 25,000 in April, 2010 in respect of the tax audit for the year ended 31.3.2010. The audit report was however signed in September, 2010. Comment.
Hint Ans: A person is disqualified from being an auditor if he is indebted to the company for more than Rs. 1,000. This provision for disqualification would apply only in case of an auditor appointed under the Companies Act, 1956. When a CA is appointed to conduct a tax audit u/s 44AB of the Income -tax Act, 1961, his appointment is not under the Companies Act, 1956 but under the Income-tax Act, 1961. In the Income-tax Act, 1961 there is no such provision. Mr. X would still be able to carry out audit and he would not be disqualified.

Q5. A leading jewellery merchant used to value his inventory at cost on LIFO basis. However, for the current year, in view of requirements of AS 2, he changed over to FIFO method of valuation. The difference in value of stock amounted to Rs. 55 lakhs which is

higher than that under the previous method. In such a situation, what are the reporting responsibilities of a Tax Audit under Section 44AB of Income-tax Act, 1961.

Hint Ans: The change in the method of valuation of stock is not a change in method of accounting, as it is only a change in accounting policy. However in the Income-tax Act, 1961 this is considered under method of accounting. Under the Income-tax Act, 1961, if the change in method of valuation is bonafide, and is regularly and consistently adopted in the subsequent years as well, such change would be permitted to be made for tax purposes. In the instant case, the change in the valuation of stock from LIFO basis to FIFO basis is pursuant to mandatory requirements of the AS 2 'Valuation of Inventories' and therefore should be viewed as bonafide change. This apart, the tax auditor in his report has to specifically refer to the method of valuation of stock under Clause 12 in Form 3CD.

(a) Method of valuation of closing stock employed in the previous year.

(b) Details of deviation, if any, from the method of valuation prescribed under section 145A and the effect thereof on profit or loss.

The auditor has to see that the method of stock valuation is followed consistency from year to year. It is also necessary to ensure that method followed for valuation of stock results is correct profits or gain. The change from LIFO to FIFO is bonafide, the disclosure of which would have to be made in the FS. As far as section 145A is concerned, tax auditor need not change the method of valuation of purchases, sales & inventories which is regularly employed by assessee. All that he has to do is to adjust the valuation for any tax, duty, cess or fee actually paid or incurred by the assessee, if the same had not already been adjusted.

Q6. Mr. Ram, the Tax Auditor finds that some payments inadmissible u/s 40A(3) were made, and advised the client to report the same in form 3CD. The client contends that cash payments were made since the other parties insisted upon the same and did not have Bank Accounts. Comment.

Hint Ans: The audit under section 44 AB of the Income Tax Act 1961 requires that the tax auditor should report whether in his opinion the particulars in respect of Form 3CD are true and correct. It is the primary responsibility of the assessee to prepare the information in form 3CD. The auditor has to examine whether the information given is true and correct. The form 3CD is not a report of Tax Auditor. The report is in the form of 3CA or 3CB depending on the nature of the organization of the entity. If the tax auditor is satisfied that the information contained in form 3CD is true and correct then he can give unqualified report in form 3CA or 3CB. But in the given case the tax auditor has found that the form 3CD contains the incomplete, misleading and false information. Disallowance under section 40A(3) is attracted if the assessee incurs any expenses in respect of which payment of aggregate of payments made to a person in a day, otherwise than by an account payee cheque drawn on bank or account payee draft exceeds Rs. 20,000/-. However, exemption is provided in respect of certain expenditure in Rule 6DD. In such cases, disallowance under section 40A(3) would not be attracted. Under clause 17(h) of Form 3CD, amounts inadmissible under section 40A(3), read with Rule 6DD, have to be reported. Cash payment made on insistence of other parties on the contention that they do not have bank accounts is not covered under the list of exceptions provided under Rule 6DD. Mr. Ram has to report the payments inadmissible under section 40A(3) under clause 17(h) of Form 3CD.

Q7. Mr. V carries on the business of dealing and export of diamonds. For the year ended 31st March 2012, you as the tax auditor, find that the entire exports are to another firm in U.S.A. which is owned by Mr. V's brother.

Hint Ans: Clause 18 of form 3CD, annexed to tax audit report in Form 3CA/3CB, requires the tax auditor to specify particulars of payments made to person specified u/s 40(A)(2)(b) of the IT Act 1961. Persons specified in the said section are relatives of an assessee and sister concerns, etc. Mr. V has not made any payments to his brother. On the contrary, he must have received payments from him against exports made and, thus, this clause would

be required to verify whether the exports are genuine, i.e. , whether the diamonds have been delivered by verifying the necessary delivery documents, relevant invoices, etc., the reasonableness of the price and whether the export realization have been received

Q8. TUI Ltd. an Indian company, subject to IT Act, 1961, discloses advance Income-tax paid (Current tax asset) and provision for Income-tax (Current tax liability), separately in B/S for the year ended 31.3.2011, i.e., it does not offset the amount. Comment.
Hint Ans: As per **AS 22** – Accounting for Taxes on Income, an enterprise should offset assets and liabilities representing current tax if the enterprise: **(i)** Has a legally enforceable right to set off the recognized amounts and **(ii)** Intends to settle asset & liability on a net basis.
An enterprise will normally have a legally enforceable right to set off an asset and liability representing current tax when they relate to income taxes levied under the same governing taxation laws and the taxation laws permit the enterprise to make or receive a single net payment. Since TUI Ltd is an Indian Company, and as per IT Act, 1961, such set off is allowed which is legally enforceable. In view of Provisions of AS 22 and IT Laws, TUI Ltd. should offset advance tax paid against provision for IT & show only the net amount in B/S.

Q9. ABC Printing Press, a proprietary concern, made a turnover of above Rs. 63 lacs for the year ended 31.03.2011. The Management explained its auditor Mr. Z that it undertakes different job work orders from customers. The raw materials required for every job are dissimilar. It purchases the raw materials as per specification/requirements of each customer, and there is hardly any balance of raw materials remaining in the stock, except pending work-in-progress at the year end. Because of variety and complexity of materials, it is rather impossible to maintain a stock-register. Give your comments.
Hint Ans: The explanation of the entity for the use of varieties of raw materials for different jobs undertaken may be valid. But the auditor needs to verify the specified job-orders received and the different raw materials purchased for each job separately. The use of different papers (quality, quantity and size) ink, color etc. may be examined. If possible, the auditor may also enquire with the other similar printers in the locality to ensure the prevailing custom. At the same time, he has to report and certify under the Para 28(b) and Para 9(b) of Form 3CD read with the Rule 6G (2) of the Income-tax Act, 1961, about the details of stock and account books (including stock register) maintained. He (or his deputy) must verify the closing stock of raw materials, work-in-progress and finished goods of the concern, at least on the date of its balance sheet. In case the said details are not properly maintained, he has to specifically mention the same with reasons for non-maintenance of stock register by the entity.

Q10. A Co-operative Society having receipts above Rs. 60 lakhs gets its accounts audited by a person eligible to do audit under Co-operative Societies Act, 1912, who is not a CA. State with reasons whether such audit report can be furnished as tax audit report under Section 44 AB of the Income-tax Act, 1961?
Hint Ans: Proviso to Section 44AB lays down that where the accounts of an assessees are required to be audited by or under any other law, it shall be sufficient compliance with the provisions of this section, if such person get the accounts of such organisation audited under such other law before the specified date and furnishes by that date the report of the audit as required under such other law and a further report by an accountant in the form prescribed under this section.
In the case of any assessee like co-operative society where the accounts under the relevant law are allowed to be audited by a person other than a CA, the statutory auditor need not be a CA. Thus, it shall be sufficient compliance with the provisions of this section and can be considered under section 44AB.

QUESTIONS

Q1. State whether a Tax audit report can be revised and if so state those circumstances. (4 Marks) **(Nov 2008)**

Q2. Draft an Audit programme for conducting the audit of a Public Trust registered under section 12A of the Income Tax Act, 1961.(8 Marks) **(June 2009)**

Q3. As the tax auditor of a non-corporate entity u/s 44AB of the Income Tax Act, 1961, how would you ensure compliance of section 145 of the IT Act, 1961? (8 Marks) **(June 2009)**

Q4. 'A' Limited has paid MAT for the year ended 31st March, 2009. It wants to disclose the same as an 'Asset' since co. is eligible to claim credit for the same. (5 Marks)**(Nov 2009)**

Q5. Discuss briefly Accounting standards to be followed by assessees under the Income-tax Law. (4 Marks) **(Nov 2009)**

Q6. T Ltd. an Indian company, subject to Indian Income tax Act, 1961, discloses advance Income-tax paid (Current tax asset) and provision for Income-tax (Current tax liability), separately in B/S for the year ended 31.3.2011, i.e., it does not offset the amount. Comment (5 Marks) **(May 2010)**

Q7. Write short notes on the major steps required in preparation of Tax audit under VAT. (5 Marks) **(May 2010)**

Q8. Mr. R, the Tax Auditor finds that some payments inadmissible under Section 40 A (3) were made, and advised the client to report the same in form 3CD. The client contends that cash payments were made since the other parties insisted upon the same and did not have Bank Accounts. Comment (5 Marks) **(Nov 2010)**

Q9. While conducting the tax audit of A & Co. you observed that it made an escalation claim to one of its customers but which was not accounted as income. What is your reporting responsibility? (4 Marks) **(May 2011)**

16. COST AUDIT

16.1 Concept of Cost Audit - According to the Institute of Cost and Management Accountants of England, cost audit represents the **verification of cost accounts** and a check on the adherence to cost accounting plan. Cost audit, therefore, comprises:
i) Verification of Cost records; and
ii) Examination of these records to ensure that they **adhere to Cost Accounting principles**, plans, procedures and objectives.

16.2 Types of Cost Audit - Persons of varied interests (stakeholders) may require cost audit reports of a company. Accordingly, the different types of cost may be as follows:
i) Cost Audit On Behalf Of Management - The management's need for cost audit arise out of the following **objectives:**
a. Establishing accuracy of cost data
b. whether objectives of Cost Account being achieved.
c. Examine abnormal losses and gains with causes.
d. Determine unit cost of production
e. Devising proper overhead rates
f. Fixation of contract price.
ii) Cost Audit On Behalf Of Customers - In case of cost plus contracts, often the buyer insists on a cost audit to satisfy him about the accuracy of the assessed cost.
iii) Cost Audit On Behalf Of Government - The Government may need the cost audit report for the following purposes:
a. Considering the grant of subsidies to applicants;
b. Assessment of tax leviable on production, etc.
iv) Cost Audit By Trade Associations - Where the pricing of products in a particular trade are controlled by the concerned trade association, the latter may require cost audit report of its member units on the costing systems, level of efficiency, utilization of capacity etc.
v) Statutory Cost Audit - The Cost audit is also required under section 233B of the Companies Act, 1956.This is discussed later in this chapter.

16.3 Advantages of Cost Audit (May 2007, May 2010) –
Cost Audit will be advantageous to the stockholders in the following manner:
i) To Management - • Reliable data • Check on wastage • Inefficiency is identified and corrective action can be taken • It facilitates MBE (management by exception) • Valuation of closing stock • Detection of error and fraud
ii) To Society - • Fixation of Price • Justification of price increase by increase in cost of production
iii) To Shareholders - Cost Audit ensures that proper records are kept as to purchases and utilization of materials and expenses incurred on wages etc. It also makes sure that the valuation of closing stock and work-in-progress is on a fair basis. The shareholders are assured about the calculation of the profitability and thus return on their investments.
iv) To Government - • Cost plus contract • Fixation of Ceiling price • Identification of Inefficient unit • Protection to certain industries • Settlement of Trade Dispute • Promoting healthy competition among units in industry.
Cost audit and consequent management action can create a healthy competition among the various units in an Industry. This imposes an automatic check on inflation.

16.4 Cost Audit under The Companies Act –
i) The Cost Auditor is appointed by the BOD with the previous approval of CG U/S 224(1B).
ii) Under section 209 (1) (d), the CG has the power to direct any **class of companies** engaged in the process of production, processing, manufacturing or mining activities to

maintain cost records. It also possesses powers under section 233 B to direct an audit of cost records of the company.

16.5 Qualification of Cost Auditor [Sec. 233 B (1)]

The person to be appointed as cost auditor of a company is required -
i) To be a **Cost Accountant** within the meaning of Cost and Works Accountant Act, 1959
ii) To hold a **certificate of practice** issued by the ICWAI.
The cost auditor may be an individual or a firm of Cost Accountants. If CG is of opinion that required no. of Cost auditors are not available then Govt. by notification in Official Gazette may permit CA also to do the same.
Appointment Sec 233B - shall be appointed by **BOD** in accordance U/S 224(1B) and **previous approval of the CG**. Such cost audit conducted would be in addition to the Audit U/s 224.

16.6 Disqualifications Of Cost Auditor - [Sec. 233B(5)]

i) Disqualifications contained in Section 226(3) and 226(4) of the **Companies Act** i.e. the statutory disqualifications prescribed for auditor
ii) Holding appointment as the **statutory auditor** under Section 224 of the companies act.
iii) On becoming subject to any of the **disqualifications** mentioned in (i) & (ii) above after being appointed as Cost Auditor

16.7 Rights and Duties of Cost Auditor

i) Rights:

a. The cost auditor enjoys the **powers** and has the duties as contained in Section 227(l) of the **Companies Act, 1956** [vide Section 233B (4) of the Companies Act, 1956].
b. He also has the right of **access** at all times to the books and vouchers, of the company

ii) Duties:

a. The cost auditor's duty as contained in Section 233B(4) is to make a **report** to the CG in the form prescribed under the Cost Audit (Report) Rules.
b. He shall also **reply to any clarification sought** by the CLB on the Cost Audit Report submitted by him within 30 days.
c. He has to satisfy himself that cost accounting **records** have been properly maintained.
d. He has to satisfy himself that the information and data collected and compiled are correct and the **cost of production** determined is fair.

16.8 Cost Auditor's Duty Regarding Branches

i) He has to state whether **proper returns** adequate for the purpose of audit have been received from branches not visited by him.
ii) Unlike financial audit there is **no provision for separate audit** of cost records maintained at the branch.
iii) In case of branches **not carrying on any manufacturing** operation but which incur certain expenses included in the cost records of the company, the auditor is responsible for audit of record of such expenses maintained at the branch.
iv) The **form of return** from the branches should be such as would facilitate their incorporation into the main cost records. Otherwise the returns may not be considered as proper returns.

16.9 Functions of Cost Auditors

The Principal functions of a cost auditor as laid down by the ICWAI are the following:

i) Inventory

a. Is the **size** of inventory maintained appropriate with the production programme?
b. Is the **order size** optimal?
c. Does the order size and minimum inventory level consider

• Storage and interest costs. • Lead time in replenishment of stocks.
d. Does the **receipt & issue system** cause any bottle neck in Production?
e. Is there any room for controlling **inventory costs**?
f. Is the expenditure on **consumable stores** within the Standards?
g. Is the inventory as per the priced store ledger and as certified by the management physically correct?
h. Is the same amount of attention and care given to monies translated into material things like raw materials, stores and supplies of all kinds as given to liquid cash?
i. Does the issue of raw materials make the production in accordance with the standard or schedule or otherwise or covered by **authorized schedule**?

ii) Opening and Closing Stocks
a. Is the **Physical verification** correctly performed and any deviation from the recorded stock level properly adjusted?
b. Is the basis of **valuation** correct?
c. Is the **volume of stock** commensurate with the volume of Production?
d. Are the **slow moving stocks** correctly valued and whether proper measures have been taken for their disposal?
e. that the **opening stock** against various jobs really represents the actual physical stock in the production shop and is not merely an accounting figure;
f. that the responsibility of the **shop foreman** in-charge of the stock held in the production shop is clear and properly documented; that he maintains proper record of actual consumption vis-a-vis the actual withdrawal from the stock.

iii) Store Issue Procedure In Stocks - The Cost Auditor should see that:
a. Withdrawal of material & stores is scientific & covered by authorized production schedules
b. that there is no possibility for **pilferage** or loss of stock lying in the production section;
c. that **surplus materials** and scraps in production shops are promptly returned.

iv. Work in Progress - The Cost auditor should see that:
a. that work in progress has been physically verified and matched with the recorded stock;
b. that **valuation** of work in progress is correct with reference to stage of completion of each job;
c. that the volume and value of **work in progress** is not disproportionate compared with the finished out-turn.

v. Labour - The Cost auditor should see that:
a. Labour has been efficiently **utilized**
b. The Labour **costs** have been allocated to jobs with reference to time or job cards.

vi. Capacity Utilization - The Cost auditor should see that:
a. The **idle capacity** in production shop/transport facilities for distribution is not excessive;
b. That **production volume** and overall machine time utilised are commensurate. In other words, the machine hours utilised has given the optimum output.

vii) Overheads & Indirect Expenditure - The Cost auditor will see and certify:
a. that **allocation** of overheads & indirect expenses over production, sales and distribution is logical and correct;
b. that **actual** indirect expenses do not exceed the budgeted expenditure;
c. that the **allocation** of overheads over finished and unfinished Products is correct.

16.10 General Features of Cost Records

i) Materials

a. Raw Material, Processed Material, Consumable Stores, etc.
b. Separate records for material purchased, issued and balance.
c. Cost should include all direct charges up to works.
d. Separate records for wastage, spoilage losses, etc.
e. Method to adjust the loss.
f. Method of valuation- actual or standard costing.

ii) Manufactured Components and Intermediaries

a. Separate records
b. Quantity and value Wastage

iii) Stores and Spare Parts:

a. Records showing receipt issues and balances.
b. Containing all details as to their **Quantity and value** their cost includes all direct charges up to works.
c. Used parts should be charged to relevant head.
d. Wastage should be separately shown.

iv) Wages and Salaries

a. Proper Records to show attendance and earnings.
b. Records of **overtime** wages, piece rate wage earned incentive wages of casual laborers.
c. Control on **Idle time**.
d. Extent of wages and salaries **capitalized**.

v) Overheads

a. Proper maintenance of **records**.
b. Classified under works, Administration and selling and distribution overheads.
c. Allocation of overheads to department etc.
e. Allocation on any **method** other than actual, variation & its treatment should be proper.

vi) Service Department Expenses Including Expenses on Utilities

a. Expenses on **power, fuel, water and steam** (purchased or generated)
b. Expenses on **subsidized canteen**.
c. Maintenance department expenses.
d. Allocation on reasonable basis.

vii) Depreciation -

a. Cost, date of installation, rate of depreciation and amount of depreciation provided
b. Treatment of **old assets**, which are fully depreciated, but still in use.
c. Minimum rate of depreciation in Company Act.
d. AS-6.

viii) Packing

a. Quantity and cost of packing material.
b. Wages and other expenses on packing.
c. Income received by sale / disposed of spoiled, rejected waste materials.

ix) By-Products

a. Proper records.
b. Proper records showing Receipt, issues and Balance (quantity and value).
c. Basis of valuation.

d. Sales realization.
e. Expenses on further process of by-product.

x) Production and Sales
a. Records (quantity and value)
b. Separate records of packed and unpacked finished goods.
c. Records of Sales and Inventory.

xi) Variances
a. If Standard Costing; other than actual, procedure followed to work out cost of products.
b. Reasons for **variances**.

xii) Cost Statements
a. As part of cost records.
b. w.r.t. each product.
c. Form of cost sheet (prescribed).

xiii) Reconciliation of Cost and Financial Accounts
a. These **two** are reconciled to ensure **accuracy**.
b. Variations should be clearly indicated and explained.
c. Period of reconciliation should **not be more** than the financial year of company.
d. Difference between sales realization and total cost is ascertained and then it is reconciled with financial profit and loss account for the **period**.
e. However, **specific information** in both accounts should not be different.

xiv) Royalty
a. Records of **Royalty** paid should be maintained.
b. Examine with **terms** of agreement.
c. Basis of computation should be appropriate.
d. Allocation to different cost centers, etc. should be as per appropriate rate.
e. Ascertain if it is a **direct charge** or overhead.

xv) Statistical Records
a. Records w.r.t. Plant utilization, idle machine time, capital employed, capital W.I.P.
b. Percentage of different raw materials.
c. To have **control** over various operations and costs.

xvi) Incorporation of Provisions Relating to Inter-Company Transfer In the Cost Accounting Record Rules
a. Normally, **no** intercompany transfer can take place below cost.
b. Ensure against **shifting of profits** between corporate investors.
c. Proper valuation of inter-company transfer to generate revenue (duty and tax).

16.11 Steps In Cost Audit - Cost Audit comprises of 3 stages:
i) Review Stage - The auditor's review should cover the following aspects:
• Nature of Industry • Production methods / processes • Important raw materials and their sources. • Licensed capacity and installed capacity. • Method of costing in use • Method of accounting of raw materials, stores and production. • Method of accounting of wastages, spoilages, rejections. • Records relating to jigs and dies. • System of wages, salaries and overtime payments including incentive scheme if any. • Basis of allocation of overheads to cost centers and of absorption to products. • Method of allocation of service department expenses • Treatment of interests and borrowings. • Agreement with collaborators for payment of royalty. • Method of Accounting for Depreciation. • Treatment of research and

development expenses. • Accounting for sales and purchases, treatment of sales tax, excise duty etc. • System of year end stock taking. • Method of determination of work-in-progress. • Inventory valuation policy and method. • System of budgetary control. • System of internal control. • State of internal control over cost accounts and cost accounting records. • Cost accounting manual, if any. • Special cost accounting practice and methods peculiar to the industry under audit.
Besides the above points the auditor should obtain and study the memorandum and articles of association of the company, past audit reports, reports of board of directors. He should also obtain an understanding of production process.

ii) Verification Stage - The cost auditors will carry out the verification of the following aspects:
• Licensed capacity and utilized capacity. • Financial Ratios. • Production data. • Cost of raw materials consumed. • Cost of power and fuel. • Employee cost. • Cost of stores etc consumed. • Provision for depreciation. • Overheads and other allocations. • Royalty and technical aid payment. • Sales - local and export • Abnormal non-recurring and special costs. • Cost statements. • Reconciliation with financial books.

iii) Reporting Stage - Upon completion of costing and other relevant records, the cost auditor should submit to the CG the report in terms of section 233B of The Companies Act, 1956 a copy of the report to the company. The auditor should also answer any query raised by the CLB on the audit report.

16.12 True and Fair Cost Of Production

i) The cost auditor is required to **express his opinion** on true and fair cost.
ii) The cost is said to be true and fair if:
a. Accepted Cost Accounting Principles have been applied while arriving at the cost.
b. Costing principles are applied on a **consistent** basis.
c. Costing system **appropriate** to product is used.
d. All Material items are considered while arriving at the cost.
e. Cost sheet is prepared in prescribed form.
f. There is elimination of **prior period adjustments** in cost sheet.
g. Abnormal losses are ignored in determination of cost

16.13 Auditors Report under Cost Audit (Report) Rules, 1968 - The cost auditor is **required to report** whether he has **obtained all information** and explanations, whether the company keeps proper cost accounting records, whether in his opinion, the company keeps the records, and whether in his opinion, the records give a true and fair view of the cost of production. As per the Cost Audit (Report) Rules, 1968 an annexure should be appended to the auditor's report. This annexure should contain **auditor's comments** on the following **14 points:**
i) General information about the company along with current years audited accounts.
ii) Cost accounting system operated by the company.
iii) General financial appraisal in areas of: • Capital employed. • Sales of the product under audit. • Operating profit of the relevant product. • Value addition in the product under audit.
iv) Registered capacity of the plant.
v) Process of production employed by the Company.
vi) Raw material consumed in the manufacture of the product.
vii) Quantity and cost of power and fuel consumed.
viii) Wages and salary expenditure.
ix) Expenditure on repairs and maintenance.
x) The method of depreciation adopted by the company
xi) All overheads classified under four major categories viz, factory overheads,

administrative overheads, selling overheads and distribution overheads.
xii) Net sales of the product under audit
xiii) Abnormal and non-recurring costs.
xiv) Auditors observations and conclusions on the following matters:
• Matters which appear to him clearly wrong in principle or apparently unjustifiable
• Cases where company's funds have been used in a negligent or inefficient manner
• Factors which could have been controlled but have not been controlled resulting in increase in wastage or cost of production
• Contracts or arrangements, if any, between the company and the other parties relating to selling, purchasing etc. by bringing out any peculiar feature, undue benefits etc.
• The adequacy or otherwise of the internal control system, if any in vogue in the company.

The **first part** of the auditor's report contains reporting on elements of **propriety**. In the **second part** of the report the auditor suggests **measures for improvement** in performance if any, in respect of the following, namely:
• Rectification of general imbalance in production facilities • Fuller utilization of installed capacity • Concentration on areas offering scope for: **a.** Cost reduction; **b.** Increased productivity; **c.** Key limiting factors; and **d.** Improved inventory policies.
The auditor may give other observations and conclusions, if any relevant to the cost audit. The report, suggestions, observations, conclusions given by the cost auditor under this paragraph should be based on verified data, reference to which shall be made here and shall, wherever practicable, be included after the company has been afforded an opportunity to comment on them.
If as a result of the examination of the books of accounts, the cost auditor desires to give a qualified report, he shall indicate the extent to which he has to qualify the report and the reasons therefore.

16.14 Advisability of Combining Cost Audit and Financial Audit to Produce Composite Audit Requirements

i) The question of combining cost audit and financial audit to produce composite audit requirements would mainly depend upon whether **objectives** of cost audit and financial audit are common.

ii) The main objective of Financial Audit is to express an **opinion** on the true and fair information provided by the financial statements while the main objective of cost audit is to **verify the cost statements** and ascertain that cost of production is true and fair.

iii) Cost audit can be considered as a **tool of internal management** by a company to operate effectively by disclosing weakness in cost accounting system and disclosing inefficiencies at all levels of organization. The financial audit on the other hand is conducted on behalf of **shareholders** and is directed to ascertain true and fair view of financial information.

iv) The **maintenance** of cost accounting records by **all types of industries** may also **not** be practicable.

v) In **practice,** it would be very **difficult to reconcile** the audit reports because the objectives of the two audits are all together different.

16.15 Distinguish Between Financial Audit And Cost Audit

Financial Audit and Cost Audit are not conflicting in nature. They reinforce each other. However, the following major differences can be identified between them –

Particulars	Financial Audit	Cost Audit
Coverage	Covers financial transactions & procedures. Does not consider cost transactions.	Covers Cost transactions, policies, procedures and techniques in great detail.
Mandatory Nature	Compulsory under law for all Companies.	Not compulsory. Prescribed only for specified industries from time to time.
Major Objective	Expression of opinion on True and Fair view presented by the financial statements.	Expression of opinion on propriety of expenditure, efficiency of performance etc.
Periodicity	Usually 1 year.	As per the Govt. order or at regular intervals which may exceed 1 year.
Appointment	Members in the AGM.	The BOD with prior approval of CG.
Report	To the Members.	To the Govt., with a copy to the Co.

CASE STUDIES

Q1. Explain briefly "True and Fair Cost of Production".
Hint Ans: **Refer** to Point No. 16.12

Q2. What are the advantages that accrue because of a Cost audit to the following:
(1) To Management, (2) To Society, (3) To Shareholder, (4) To Government
Hint Ans: **Refer** to Point No. 16.3

Q3. "Like every other audit, a systematic planning for cost audit is also necessary". Indicate the matters to be included in a Cost Audit Programme.
Ans: It is a true statement that likes any other audit a systematic planning for cost audit is also necessary. Therefore, the cost audit programme should include all the usual broad steps that a financial auditor includes in his audit programme. This would require that the various aspects like what to be done, when to be done and by whom to be done are adequately takes care of. However, looking to the basic difference in cost audit and financial audit as allocation and apportionment of expenses, statutory requirement etc. should require special consideration. Cost audit, in order to be effective, should be completed at one time as far as practicable. Based on above factors a set of procedures and instructions are evolved which may be termed the cost audit programme. Matters to be included in the Cost Audit Programme may be divided into following two stages:
(i) Review of Cost accounting record – **Refer** 16.11 (i)
(ii) Verification of cost statement and other data – **Refer** 16.11 (ii)

Q4. State the functions of Cost Auditor in respect of the following:
(i) Inventory, (ii) Labour, (iii) Overhead and indirect expenditure, (iv) Work in Progress.
Hint Ans: **Refer** to Point No. 16.9

QUESTIONS

Q1. What is the purpose served by Introduction of Cost audit? (4 Marks) **(May 2010)**

Q2. Write short notes on Reconciliation of Cost & Financial A/c. (5*4 Marks) **(Nov 2010)**

17. SPECIAL AUDIT ASSIGNMENTS

17.1 AUDIT OF STOCK EXCHANGE

17.1.1 Members of Stock Exchange - Only the **members** of the exchange can do trading at stock exchanges. Each stock exchange has its own **rules** for admission of members.

17.1.2 Margins

i) Need for margin

a. Due to wide **fluctuations** in prices of securities over a period of time, the exchange levies margin on its members.
b. This certain deposit is to be **kept with exchange** by its members.
c. This mechanism is adopted, in order to **restrict excessive speculations** and safeguard the interest of the investors

ii) Where to deposit - The members collect margins from their clients and deposit it with the **clearing house** of exchange.

iii) Types of margin – Generally, there are **6 types** of margin:

a. Volatility Margin

• The volatility margin is levied to **curb excessive volatility** in the securities.
• It is also used to prevent building up of excessive **outstanding positions**.
• This margin is **calculated** at the **discretion of stock exchange** to charge margin on a particular security because of its volatile nature, on specific percentage.

b. Gross Exposure Margin

• It is the percentage of **net cumulative outstanding position** in all securities that the member is required to keep with the exchange at all times.
• This margin is calculated on **continuous** basis.
• This margin is to be kept: with stock exchange in **advance.**
• Gross exposure is calculated on **all securities** unlike volatility margin which is on any specific security.

c. Mark to Market Margin

• This margin is imposed to **cover a loss that a member may incur**, in case the transaction is squared off at the closing price of the trading day, which is different from the price at which the transaction has been entered into.
• It is the **notional loss** if net cumulative outstanding position in all the securities were closed out at closing price of relevant transaction date, for a specific member.

d. Additional Volatility Margin
e. Special Margin
f. Adhoc Margin

17.1.3 Trading On the National Stock Exchange –

i) NSE operates on the 'National Exchange for Automated Trading' **(NEAT) system**;
ii) It is a fully **computerized** screen based trading system.
iii) It enables members from across the country to **trade** simultaneously with enormous ease and efficiency by keying the order into the system.
iv) A **single consolidated order book** for each stock displays, on a real time basis, buy and sell orders originating from all over the country.
v) The orders are executed only if the **price-quantity conditions match**.

17.1.4 Types of Market – There are **4 types** of market:

i) Normal Market - In normal market, those orders are traded which are of the **regular lot size** or multiples thereof. Now a days, for demat shares, lot size is 1 share.

ii) Odd Lot Market - The odd lot market facility is used for the limited **physical market**. In odd lot market, those **orders** are traded which are **not of the regular lot size**. The orders are called as odd lot orders if the order size is less than the regular lot size. But, in odd lot market, **both price and quantity should tally** with each other for order matching.

iii) Spot Market - Spot orders have **different settlement periods** vis-à-vis normal orders. In spot market, Pay in and pay out takes place on the same day.

iv) Auction Market - Auctions are **initiated by the exchange** on behalf of trading members for settlement related reasons. The main **reasons** are Shortages and Bad deliveries. Exchange initiates auctions to purchase from the market, the number of shares short deposited by the members. Thus, they complete the settlement process. Loss is recovered from members.

17.1.5 Order Books

i) Storage in Order Book

a. As and when orders are received by the system, they are first numbered, **time stamped** and then scanned for a potential match.
b. If a match is not found, then the orders are **stored** in the different books as per **price / time priority.**
c. Thus, for order matching, **top priority** is given to the **price**. If many orders are entered at the same price, then priority is given to the order which was entered earlier.

ii) Types

a. Regular Lot Book - This book contains only regular lot orders and orders.
b. Stop-Loss Book

• Stop loss orders allows the user to **release an order** into the system, after the market price (last traded price) reaches or crosses a threshold price called '**trigger price'***.
• ***'Trigger price'** is the price at which an order gets triggered from the **stop loss book**.
• These orders are **stored** in this book **till the LTP** in market reaches or cross the trigger price, and then the order is released in the regular lot book:
~ Stop loss Buy Order - It gets triggered when the last traded price reaches or **exceeds** the trigger price of the order.
~ Stop loss Sell Order - It gets triggered when the last traded price reaches or falls **below** the trigger price of the order.
c. Odd Lot Book - All orders in odd lot market (having quantity less than marketable lot) are stored in this book.
d. Spot Book - All orders of spot market are stored in this book.
e. Auction Book - It contains orders which are entered during **auction market**.

iii) Order Matching Rules

a. As and when orders are received by the system, they are first numbered, **time stamped** and then scanned for a potential match.
b. In stock market, the **best buy-order** at any point of time is matched with the **best sell order** at that time.
c. A seller wants to sell at the highest available price.
d. Thus, the **'best buy-order'** is the order with the **highest price**.
e. Same ways, a buyer would like to buy at the lowest available price.
f. Thus the **'best sell-order'** is the order with the **lowest price**.
g. Thus, the trading system tries to find for the seller the best possible buying price and the best possible selling price for the buyer.

h. Orders that match with other orders are called '**active' orders** while those, which do not match, are called '**passive' orders**.
i. If a **match** is **not found**, then orders are stored in the books as per price/time priority.

iv) Order Conditions
a. Time Related conditions
• **Day order -** Presently **all orders** entered into the system are **considered as Day orders** only. This order is valid only for the day on which it is entered. If it is not matched till end of the day, it is **automatically cancelled**.
• **Good Till Cancelled order -** It remains in the system until it is cancelled by the trading member. Now a day, this condition is not available in the trading system of stock market.
• **Good Till Days/Date order (GTD) -** Here, the trading member **specifies the days/date** up to which the order shall remain valid. Now a day, this condition is not available in the trading system of stock market.
• **Immediate or Cancel order (IOC) -** An IOC order allows a member to buy or sell a security as soon as the order is released into the system. If it is **not matched** at the same moment, it **gets cancelled** right then. If it is partially matched, remaining quantity is automatically cancelled.
b. Price Related Conditions
• **Limit Price Order -** In this type of order, the trader specifies his offer price.
Buyer - Maximum price up to which he is willing to pay.
Seller - Minimum price, till which he is ready to sell
• **Market Price order -** Market orders are orders for which price is specified as "MKT' at the time the order is entered. For such orders, the **system determines the price** which is available in market at that point of time.
• **Stop Loss Price Order -** This facility allows the user to release an order into the system, after the market price (last traded price) reaches or crosses a threshold price called **trigger price**. **(Refer to stop loss book).**
c. Quantity Related Conditions
• **Disclosed Quantity Order (DQ) -** An order with a Disclosed Quantity allows the user to **disclose only a portion** of the order quantity to the market. For example, if the order quantity is 1,000 and the disclosed quantity is 200, then only 200 is revealed to the market. After this quantity is fully matched, a subsequent quantity of 200 is disclosed.
• **Short Sell -** The seller sells the shares even if he doesn't own them. These are **speculative order** (for bear). In this case, the orderer anticipates a decline in the price of shares. However, it is risky as he has to square up the transaction within the day.

17.1.6 Settlement System at Stock-Exchanges
i) Accounting Period Settlement Systems
a. Previously in India, this kind of settlement system was operational, which is now replaced by rolling settlement system.
b. Under this system, **total trades** of a particular trading member are **aggregated over a 7 days period.**
c. Cumulative **net obligations** of each member are calculated on last day of this trading cycle.
d. It used to be more speculative than the rolling settlements. It might lead to payment crisis in case of wide fluctuations in the market.
e. Now it is not in operation in India.

ii) Rolling Settlement
a. In rolling settlement, the trades of each day are **settled after 2-3 days**.
b. (T + 3) rolling settlement was in operation in India up to 31 March, 2003, which was switched on to "T + 2" rolling settlement system from 1 April, 2003.

c. In T+2 rolling settlement system Trades outstanding at end of day are to be **settled** within 2 business day from transaction.
d. For example, in T + 2, if transactions are entered into on Monday, their pay in and pay out takes place on Wednesday.
e. Thus, Trades on each single day settled separately from trades done earlier or subsequent trade days.
f. Netting of trades is done only for the day and not for multiple days (as earlier in settlement period)
g. It adopts VAR (Value At Risk) based margining approach.
h. If member fails to deliver shares sold, the exchange conducts an auction session on T + 3 to meet short fall due to non-delivery.

17.1.7 Audit of Accounts - All **"active members"*** of stock exchange are required to get their accounts audited by a CA in practice. ***"Active member"** is any member who has conducted business in stock exchange even for a single day in the year.

i) Considerations By Auditor W.R.T. Some Important Books/ Accounts / Sauda Book / Daily Transactions List

a. It is the **basic record** maintained by the members.
b. It contains details of all the **transactions entered** by them.
c. It is continuously **updated** during the day.
d. At end of day, it shows all transactions entered into by **stock broker**.
e. It contains information on –
• Securities traded • Rate of securities bought and sold • Quantity of securities bought and sold • Time of transaction • Number of transaction • Name of the client.
f. Now a day, it contains a record of **following categories** of transactions –
• Member's own business on the exchange • Member's business on behalf of his clients
• Member's business with his clients on a principal to principal basis • Spot transactions

ii) Contract Notes - W.r.t. contract notes issued by the members to its client, it should be ensured whether -
a. The member has issued contract notes to its clients within **24 hours** of the execution of transactions on their behalf.
b. Contract notes are serially **numbered**
c. Any serial number is **left blank**
d. These are in the **format** prescribed by relevant exchange
e. Duplicate copies of contract notes are being maintained by the members.
f. Brokerage has been shown separately and charged within specified limits (max. 2.5%)
g. Ordering time is reflected on contract notes along with the time of execution of order.
h. Member/authorized signatory have **signed** the contract notes.
i. Brokerage, **Service Tax** and Security transactions Tax shown separately.
j. PAN number of client has been mentioned on contract notes if required.

iii) Margin Deposit Book - It records the margin deposited by the member with the Clearing house of the relevant stock exchange. The auditor should check:
a. Whether margin has been in accordance with **SEBI guidelines**.
b. That it is as per the **margin statement** downloaded from the stock exchange
c. Whether margins have been **properly calculated**, **collected** from clients and paid to the clearing house.
d. Any **exemptions** from deposit of margin have been correctly claimed.

iv) Dematerialized Securities

a. Every member has to maintain **two demat accounts**.
b. One demat account is used to hold its **own securities** known **as 'Beneficiary Account"**

c. The other one is meant for trades executed **on behalf of clients** known **as 'Pool A/c'.**
d. The securities to be sold are transferred to the Pool Account from where these are given to the clearing house on the relevant pay in day.
e. The securities received in pool account must have been transferred to client's Demat Account within **48 hours.**
f. There should be **valid reasons** with authorization from client for holding a particular security in pool account for longer period.
g. Securities lying in pool account must have **not been used** to settle member's own trade obligations.

v) Audit Report - At a Glance
a. We have **audited Balance Sheet** and Profit and Loss account of.....
b. We have **obtained all necessary information** and explanation
c. Proper books of accounts and records specified by securities contracts (regulation) rules are kept.
d. Broker has **complied with requirement of exchange**, So far as they relate to maintenance of accounts and was regular in submitting required information to Exchange.
e. In our opinion and to best of our information, F.S. represents **true and fair view.**

17.1.8 SEBI's Checklist For Auditors In Respect Of Contract Notes Issued By A Stock Broker: (May 2007)

i) Members should **issue Contract Notes** to his clients for trades executed on their behalf.
ii) The member should **stamp** his **order sheets** / records and the order time should be reflected in the Contract Note along with the time of execution of order.
iii) The Contract Notes should bear **SEBI Registration number** of the member. If should be pre printed and issued within 24 hours of trade execution. Appropriate stamps should be affixed on the contract Note. Duplicate copies of the contract note should be maintained.
iv) The Contract Note should be **signed** by the member or his constituted attorney.
v) Contract note issued to the clients should show the **brokerage** separately.
vi) In case the broker acts as a principal, the Contract Note should be in **Form B.**
vii) Consent of client should be taken for trade done by broker while acting as principal.
viii) Brokerage should be within the **limits prescribed** by the exchange.

17.1.9 Circuit Filters: (Nov. 2007)

i) Circuit breakers or filters are the **price bands** that set the upper arid lower limit within which a stock can fluctuate on any particular day.
ii) A price band for a day is a function of previous trading days' closing.
iii) SEBI has directed exchanges to apply circuit filters on scrips traded in rolling settlement if their price fluctuates **more than 20%** of the closing price of scrips on the previous day in any direction.
iv) For **scrips forming part of sensex** or in which derivatives and futures are available, the fluctuation is restricted to **10%.**

17.2 AUDIT OF DEPOSITORIES

17.2.1 Basic

i) In India, NSDL and CDSL **keep record of ownership** of securities electronically in book entry form.
ii) Transfer of ownership of securities is done by simple account transfers.

17.2.2 Advantage

i) Liquidity of scripts (immediate transfer and register).
ii) Receive bonus and right as direct credit to A/c.

iii) Much **lower risk** of bad deliveries.
iv) Saving of **stamp duty**.
v) Saving of **courier charges**.
vi) No physical certificates (no risk of getting them misplaced).
vii) Reduction in **brokerage**.

17.2.3 Maintenance of Documents - To maintain **following** records and documents: • Record of securities Dematerialized/re-materialized. • Transferor, transferee and date of transfer. • Register of beneficial owner (B.O). • Instructions received. • Allotment notice. • Records w.r.t. pledge of shares. • Details of participants. • Details of securities eligible for DEMAT. • Other records specified by board.

17.2.4 Other Requirements - • Intimate SEBI the place of maintaining records and documents. • Preserve for minimum 5 years. • If kept electronically, ensure integrity of system and precaution.

17.2.5 Inspection - SEBI may appoint one/more inspecting officer for **following purposes**: • Ensure that books of accounts maintained by depository, participants or agents. • Look into complaints of account holders. • Whether provision of Act, Bye-Laws, etc. are being complied with. • Whether system, procedures are being followed. • Affairs conducted in interest of investors or securities market.

17.2.6 Reconciliation Of Change In Share Capital
• Every issuer shall submit on a **quarterly basis**, the details of changes in share capital during the quarter to the concerned stock exchange. • It should be audited by a qualified CA or a practicing CS. • It is submitted for the purpose of reconciliation of total issued capital, listed capital and capital held by the depositories in DEMAT form. • It should also contain an updated status of register of members of issuer. • Further, the issuer shall immediately bring to the notice of the depositories and the stock exchanges, any differences observed in its issued, listed and the capital held by depositories in demat form.

17.3 AUDIT OF MUTUAL FUND

17.3.1 Basic
i) Auditor is to be **appointed by trustees**. Report is also forwarded to trustees.
ii) Every **asset management company** to **keep** proper books of accounts and, records for each scheme.

17.3.2 Audit Report
i) The auditor has obtained **all information** and explanation which, to the best of his knowledge and belief, were necessary.
ii) The Balance Sheet and Revenue Accounts give a **True and fair view.**
iii) The accounts have been prepared in accordance with **Ninth Schedule.**

17.3.3 Inspection & Audit - SEBI may appoint one or more persons as inspecting officer for ascertaining the **following**: • Books of accounts are being maintained by MF • Provision of Act is complied with. • System, procedure is adequate. • Provision of Act or rules are violated. • Investigate into complaints. • Affairs are in interest of investors.

17.3.4 Requirement Of Ninth Schedule [Mutual Funds (MF)]
i) MF mark **all investments** to market & carry investments in **B/S at Market value**.
ii) Dividend / Bonus to be recognized on the date when share is **quoted** on Ex-dividend/Ex-Bonus basis on Stock Exchange & not on date of declaration.

iii) For interest bearing investments, **interest income** must accrue on day to day basis.
iv) For determining holding cost of investment, **'Average Cost'** method is to be followed.
v) Transaction of purchase/sale of investment to be recognized as of **trade date** & not as of settlement date.
vi) Where **interest on investment** has been accrued & hasn't been received for 12 months beyond due date, provision is to be made for income as accrued & no further accrual is made for such investment.
vii) For **open ended scheme**, difference between Selling Price & Face Value of unit should be credited / debited to reserve. Face Value being credited to capital account. The treatment of equalization account is to be taken care of.
viii) For **close-ended scheme**, the par value of unit has to be adjusted to capital Account & difference should be to reserves.
ix) Cost of Investment should include brokerage, stamp & any other direct charge.
x) Underwriting commission is recognized only if there is no development on the scheme. Where there is development, the full commission received should be reduced from the cost of investments.

17.4 ENVIRONMENTAL AUDITING

17.4.1 Meaning

i) It examines **environmentally related data** regarding environmental risks, its impact, policy target, cost and performance, etc. to interested parties.
ii) Multi-disciplinary. Thus, a team of experts from various disciplines conducts it.
iii) It is mainly meant for **Internal use.**

17.4.2 Requirement in India - In India, Environmental Impact Assessment **(EIA)** is a pre-requisite to start an industry, which **forecast the expected damage** to the environment and means required to mitigate the damage.

17.4.3 Objective - Its objective is to evaluate the efficiency of the utilization of resources and identifying the areas of risks and to control the generation of pollutants and waste etc.

17.4.4 Aspects To Be Covered:

i) Layout and design: Adequacy of provision for pollution control measures etc.
ii) Pollution Control System: It should be in existence.
iii) Management of resources: It should be used in such a manner to produce best output and minimum waste.
iv) Environment Safety Measures: like emergency plans, awareness etc. to meet the contingency.
v) Medical & Health care facilities: There should be adequate facilities regarding workers.
vi) Industrial Hygiene: There should be cleanliness and hygienic environment in the premises.
vii) Occupational health: These are health hazards which arise according to type of industry. They should take proper steps to protect health of workers.
viii) Information Assimilation and Reporting System: Authorities and responsibilities should be clearly defined.
ix) EIA Methodology: Degradation of Environment and mitigatory measures should be suggested.
x) Compliance to Regulatory Mechanism: To avoid penalty etc.
xi) Concern for the society: for welfare of society as a whole.

17.4.5 Audit report format -

• Name, address etc. • Date of last EAR submitted. • Consumption of input during current and previous year. • Pollution generated and types. • Generation of hazardous waste in current and previous year. • Quantity of solid waste. • Disposal practice for waste. • Practice for conservation of natural resources. • Additional proposal for environmental protection.

17.5 ENERGY AUDIT

17.5.1 Meaning

i) It is the activity that serves the purposes of **assessing energy use pattern** of a factory or energy consuming equipment and identifying energy saving opportunities.
ii) Audit team should have **representation** from various sections.
iii) A **standard** of energy/p.u. is to be derived and then it is **compared** with actual.
iv) Energy Auditor is also required to give **recommendations**

17.5.2 Function - Function of Energy Auditor are:
i) Quantify energy **cost** and **quantity.**
ii) Correlate production to energy cost.
iii) Energy database format.
iv) Compliance of organization for policy aspect.
v) Highlight areas needing attention.
vi) Conduct **preliminary and detailed energy audits** as follows:
• Data collection and analysis • Measurements, mass and energy balances • Reviewing energy procurement practices. • Identification of energy efficiency projects and techno-economic evaluation. • Establishing action plan including energy saving targets, staffing Recommendations.

17.5.3 Methodology to Energy Auditing

i) Preliminary Energy Audit:
a. It typically involves two or three days of plant visit.
b. It is also referred to as **walk-through audit**.
c. One may rely on data supplied by the unit or personally read from meters installed in the industry.
d. In many instances, the meters installed in the industry do not show accurate reading.
e. Ideally, the energy auditor must carry proper portable instruments and make **recommendations.**

ii) Detailed Energy Audit:
a. It goes much **beyond** the **quantitative estimates** of cost and savings.
b. The **scope** of the audit assignment is discussed in detail with the plant personnel.
c. The study involves detailed **examination** of major **energy consuming equipment**.
d. The study proposes specific **projects/feasibility study** for replacement proposals, providing a cost-benefit analysis of the recommended measures.

17.6 AUDIT OF ACCOUNTS OF NON-CORPORATE ENTITIES

17.6.1 For whom - For those Non-corporate Borrowers enjoying **working Capital Limits** of **Rs.25 lacs** and above from the Banking System.

17.6.2 Meaning of Borrowing - Term Borrowing includes (for purpose of limit):
• Packing Credit facility. • Cash Credit facility. • Loans. • Overdraft. • Deferred Payment facility. • Guarantee • Bill Discounting facility. • Any other Credit facility.

17.6.3 Submission of Report - To submit such audited statement and report to concerned bank, at earliest but not later than **6 months** from the close of Accounting year.

17.6.4 Audit Procedures
i) Entity may **choose** any CA
ii) He shall use his professional skills & experience and apply such audit tests as required by circumstances.
iii) He should consider **materiality** & perform **compliance procedures**.
iv) He shall obtain all **relevant information** and explanation from the client being audited.
v) He should obtain **letter of engagement and list of books** of accounts / records maintained by the entity before undertaking audit assignment.
vi) Check compliance with terms of documents etc. (**Partnership/Trust Deed**)
vii) Examine figures of **immediately preceding year** for comparisons (SA 510 and 710).
viii) Any material departure of accounting from **accepted principles / Policy** followed in preceding year should be reflected in notes to accounts / Auditor's report.
ix) Finally he shall consider whether financial statements give a **true and fair view**.
x) It should help the lending banker in **evaluation of loan proposals.**

17.6.5 Special Auditor Report
i) When required - It can be called by a lending bank, if it is required as per the **circumstances.** It is submitted on **quarterly basis** (it is in addition to normal audit report, which is done on annual basis).

ii) Information regarding:
• Actual Production. • Actual production as % of rated capacity. • Sales. • Cost of goods sold / cost of production. • Gross margin. • Interest on bank borrowing. • Interest on others. • Age-wise classification of raw material and finished goods. • Basis of valuation of raw material and finished goods. • Age wise classification of B/R and other receivables due from domestic parties and for exports. • Some ratio etc. also to be given.

iii) Information w.r.t. following needs to be provided in report:
• Balances at the end of each month of the quarter for major categories of stock, receivables and bills receivables; • Tax assessments and payments made during the quarter. • Actual disbursement of capital expenditure during the quarter; • Outstanding contracts. • The contingent liability; • Investment made during the quarter and the income from such investments including profit on sale of investments. • Loans given during the quarter; • Loans raised during the quarter • Overdue statutory liability at the end of the quarter; • Amounts due but not paid at the end of the quarter in respect of (**a**) loans from banks, (**b**) public deposits and (**c**) other loans; and • Figures of cash losses.

CASE STUDIES

Q1. What are the main areas dealt in respect of various industrial units for the Environmental Audit?
Hint Ans: Refer to Point No. 17.4.4

Q2. What are the key functions of an Energy Auditor?
Hint Ans: Refer to Point No. 17.5.2

Q3. State the items contained in the SEBI's check list for auditors in respect of contract notes issued by a Stock Broker.
Hint Ans: Refer to Point No. 17.1.8

Q4. What do you understand by the Rolling Settlements? State briefly.
Hint Ans: Refer to Point No. 17.1.6 (ii)

Q5. "In a depository system, securities are held in securities (depository) accounts; which are more or less similar to holding funds in bank accounts." In the light of the above briefly explain the provisions of depositories and its advantage?
Hint Ans: The entire transaction of purchase or sale of securities can be said to be completed only after the buyer becomes the rightful owner of the securities and the seller gets the sale consideration. Traditional settlement system on the Indian stock markets gave rise to settlement risk due to the time that lapsed before trades were settled. Further, transfer of securities involved sending the same along with sellers' endorsement on transfer deed for registration to the issuer. In many cases, the process took much longer than two months and significant proportion of transactions ended up as bad delivery due to faulty compliance of paper work. Theft, forgery, mutilation of certificates and other irregularities were rampant and in addition to the issuers right to refuse the transfer of security. To obviate these problems, the Depositories Act, 1996 was enacted to provide for establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security by:
(a) Making securities of public limited companies freely transferable subject to certain exceptions;
(b) Dematerializing the securities in the depository mode; and
(c) Providing for maintenance of ownership records in book entry form.
In order to streamline both the stages of settlement process, the Depositories Act, 1996 envisaged transfer of ownership of securities electronically by book entry without making the securities moving from person to person. The Act made the securities of public limited companies freely transferable by restricting the company's right to use discretion in effecting the transfer of securities, thus, dispensing with the transfer deed and other procedural requirements under the Companies Act, 1956.
Refer to Point No. 17.2.1 & 17.2.2

QUESTIONS

Q1. Write short notes on the following:
a) Circuit filters/Circuit breakers. (4 Marks) **(Nov 2008, Nov 2010)**
b) Purpose of appointing Inspecting officer of a Depository. (4 Marks) **(Nov 2008)**

Q2. Short notes on Probable format of Environmental Statement (4 Marks) **(June 2009)**

Q3. Write short notes on the Mark to Market margins. (4 Marks) **(May 2010)**

18. AUDIT OF PUBLIC SECTOR UNDERTAKINGS

18.1 Audit of Government Companies

i) Appointment of Auditors - Statutory Auditors of a Government Company are appointed or reappointed by the Comptroller and Auditor General of India (**C&AG**).

ii) Supplementary Audit Under Section 619 (4) Of The Companies Act, 1956:

a. In the case of a Government Company, the C&AG is **authorized** to conduct a supplementary or test audit in addition to the regular professional audit.
b. CAG may **comment** upon or supplement the report submitted by professional auditor.
c. CAG may issue **directives** to the auditors in regard to the performance of their function.
d. Person so **authorized** may well be the auditor of the company.
e. The **form and content** of supplementary audit report may be specified by CAG.
f. Supplementary Auditor may concentrate more on **efficiency** aspects.
g. The person so authorized is having **same powers** as auditors.
h. However, the **directors** are **not** required **to comment** on any adverse remark contained in the supplementary audit report.

18.2 Objectives Of Audit Of Public Sector Enterprises

i) In PSU, there is involvement of **public fund**.
ii) These funds should be utilized considering **public interest**.
iii) Normally, these funds are lavishly **used by management**.
iv) While auditing, auditor has to check whether these funds have been **used in** a manner so as to hurt the basic objectives behind creation of PSU. (**Public Welfare**).
v) Main **objective** is to check the substance of transaction entered into by the PSU.
vi) Check whether transactions mainly expenses confirmed to **propriety norms**.

18.3 Comprehensive Audit of Public Enterprises

i) Meaning

a. Comprehensive audit is **examination in detail** of various aspects of PSU to ascertain its efficiency and effectiveness.
b. The auditor herein prepares a **detailed audit program** to cover various aspects.
c. It is conducted **in addition to** the professional audit, which is done on an annual basis.

ii) Considerations by Auditor - Auditor considers **following** aspects while conducting comprehensive examination of PSU:

a. Whether **investment decisions** taken considering socio-economic objective of PSU.
b. Whether PSU considers **economy and efficiency** during its project formulation.
c. Whether MIS of PSU is providing right information on a **timely basis** on the basis of which important decisions are taken.
d. Organizational **capacity** utilization is proper or there is **under-utilization** of capacity.
e. Use of materials should be such as to produce **minimum wastages**.
f. Whether **cost control measures** being adopted by entity to keep the cost under check.
g. R&D programs are being carried out in an effective way and these are in fact fruitful.
h. Whether **repairs and maintenance** programs are being adhered to on a timely basis.
i. Its **IC systems** are operating effectively on a **continuous** basis.
j. Management of PSU is conducting its **operations** in an efficient manner.

18.4 Propriety Audit

i) Meaning

a. "Propriety Audit stands for **verification of transactions** on the test of Public Interest, commonly accepted customs & standards of conduct".
b. Propriety is that which meets the **tests of public interest**, commonly accepted customs and standards of conduct and particularly as applied to professional performance, requirement of law. Government regulations and professional codes" - E.L. Kohier.

c. It **shifts the emphasis** to substance of transaction.
d. Requires transactions (mainly expenses) to confirm to certain **general principles**:
• **Expense** is **not** prima facie **more** than the occasion demands and same degree of vigilance is exercised as should be exercised in respect of his own money.
• Authority exercises its **power of sanctioning** expenses to pass an order which will not accrue to its own advantage.
• Funds **not** utilized for **benefit of** a particular person/group.
• Apart from agreed remuneration, **no other avenue** is kept open **to benefit management** personnel, employees and others.

ii) Problems in Propriety Audit
a. It is a **moral term**.
b. Auditing requires **verifiable propositions**, establishment of which is very difficult for propriety audit.
c. It has inherent **element of subjectivity**.
d. CAG has developed **norms of propriety** for expenses of public funds but it may not apply to transactions of private sector.
e. If management **formulates** norms of propriety for the entity, the element of subjectivity will get reduced.
f. For **e.g.** - Travel by air (It may be judged as wasteful. However, it becomes feasible due to time saving).
g. The **judgment** of auditor shouldn't be subjective as far as possible.

iii) Propriety Element U/S 227(1A)
a. Whether **terms on** which secured loans and secured advances have been made are **not prejudicial** to the interests of the company or its members. Conditions like security, interest, repayment period and other business considerations.
b. Whether **transactions** of company which are represented merely by **book entries** are **not prejudicial** to the interest of company, i.e. effects of book-entries, unsupported by transactions, etc.
c. Whether **investment** of company (other than Banking/Investment company) in form of share, debenture and other securities have been **sold** at a **price lower than** its cost, i.e. to see reasonableness of decision to sell at loss.
d. Whether **personal expenses** have been charged to revenue.

iv) Propriety Element under Cost Audit Report
a. Matters appearing clearly **wrong in principle** or apparently wrong.
b. Cases where company's funds have been used in **negligent**/inefficient manner.
c. Factors which could have been **controlled** but haven't been, thus, resulting in increase in cost of production.

v) Propriety Elements in CARO, 2003
Refer CARO, 2003 in Chapter 8 "**Audit Report**"

18.5 Performance Audit - A performance audit is an objective and **systematic examination of evidence** for the purpose of providing an **independent assessment** of the performance of a government organization, program, activity, or function in order to provide information to **improve public accountability** and facilitate **decision-making** by parties with responsibility to oversee or initiate corrective action.
Performance audits include **i)** economy and efficiency and **ii)** program audits:
i) Economy and efficiency audits include determining:
a. Whether the entity is acquiring, protecting, and using its resources (such as personnel, property, and space) economically and efficiently,

b. The causes of inefficiencies or uneconomical practices, and
c. Whether entity has complied with laws & regulations on matters of economy & efficiency.
ii) Program audits include determining:
a. The **extent** to which the **desired results** or benefits established by the legislature or other authorizing body are being **achieved,**
b. The **effectiveness** of organizations, programs, activities, or functions, and
c. Whether entity has complied with significant **laws & regulations** applicable to program.

18.6 Public Accounts Committee (PAC) - The PAC satisfies itself:
i) That the moneys (shown in the accounts) were **disbursed legally** on the service or the purpose to which they were applied.
ii) That the expenditure was **authorized**.
iii) That **re-appropriation** (i.e. distribution of funds).
It is also the duty of the PAC to - **examine** the **statement of accounts** of autonomous and semiautonomous bodies, the audit of which is conducted by the **C&AG** either under the directions of the President or by a statute of Parliament.

18.7 Committees on Public Undertakings –
i) Committees on Public Undertakings have been **constituted by the parliament** to monitor the operation of PSUs closely.
ii) The Committee on Public Undertakings was set up under the Rules of Lok Sabha, which **took over the functions** of the Public Accounts Committee and the Estimates Committee.
iii) The **audit reports** (Commercial) are **examined** by the committees on public undertakings of the Parliament / State Legislatures.
iv) The committee can and does **select some enterprises** every year to examine, in the context of the autonomy and efficiency of the enterprise, whether the affairs of the selected enterprise are being managed in accordance with sound business principles and prudent commercial policies.
v) But the committee does **not examine** either: **a.** matters of major Government policy or
b. matters of day-to-day administration.
vi) The examination by the committee is based on **study tours** for on the spot study, written information called from the enterprise & oral examination separately of the representatives of the enterprise and the concerned administrative ministry.
vii) Under the existing practice, the Committee on Public Undertakings **reviews working** of the Govt. Co's & **scope** of examination and scrutiny by Committee is **unlimited.**
viii) The **review** more or less covers **all the areas** of management.
ix) The **follow-up action** on the C&AG's report, propriety as well as financial, if any, is also undertaken by the Committee on Public Undertakings.
x) The Committee has also conducted **horizontal functional studies** in areas like material management, financial management, personnel management, foreign collaboration agreements, etc. Based on the findings of the Committee on Public Undertakings, suitable instructions are issued by the Bureau of Public Undertakings for guidance of Govt. Co's.

CASE STUDIES

Q1. "Comprehensive audit involves assessing efficiency & effectiveness of public enterprises". What is Comprehensive Audit? Enlist some of the areas to be examined.
Hint Ans: Refer to Point No. 18.3 (i) & (ii)

Q2. Briefly explain the Areas of propriety audit u/s 227(1A) of the Companies Act, 1956.
Hint Ans: Refer to Point No. 18.4 (iii)

19. INTERNAL AUDIT, MANAGEMENT AND OPERATIONAL AUDIT

19.1 Internal Audit - Internal Audit means "An **independent management function**, which involves a **continuous and critical appraisal** of the functioning of an entity with a view to suggest improvements thereto and add value to & strengthen overall governance mechanism of the entity, including the entity's strategic risk management and IC system.

i) Scope Of Internal Audit – Internal Auditor's work should include a review of

a. Internal control (IC) system and procedures.

b. System regarding the custodianship and **safeguarding of assets** - monetary and nonmonetary of enterprise.

c. Compliance, by the various segments **with the policies, plans** and procedures of the enterprise as well as with the relevant regulations and laws.

d. System of collecting data both monetary and non-monetary - to ensure that the information given to management and to external agencies is relevant and reliable.

e. Organizational structure of the enterprise and congruence with its objectives.

f. Efficient and economical use of available resources tangible as well as intangible.

g. Various operations.

19.2 Management Audit

i) Meaning - "Management Audit concerns itself with **whole field of activities** of concern, from top to bottom, primarily concerned with whether the general management is functioning smoothly and satisfactorily." T.G. Rose

a. It is audit of **management performance**.

b. Primary accent is on **evaluating manager's ability** to manage.

ii) Difference Between Management And Operational Audit - "Management audit would concern itself with whole field of activities of concern from top to bottom primarily concerned with whether general management is functioning smoothly and satisfactorily." whereas, **"Operational Audit** is undertaken at the instance of management for providing it with information and appraisal of operations and activities."

Management Audit	Operational Audit
Audit of Management	Audit for management
Wider	Narrow
Quality of Managing	Quality of operational effectiveness

iii) Scope Of Management Audit

Purposes of organization	Internal controls	Reports required by the management
Management Structure	Personnel policy	Factory layout, design & installed capacity
Production planning	Books & Records.	Nature of production of Business.
Material management	Sales management	Decision making process & FM

Thus, management audit includes all the elements of operational audit also.

iv) Need / Desirability Of Management Audit

a. For detecting and overcoming current problems - Managerial problems and related operational difficulties can be spotted before their adverse effects. This is thus forward looking approach.

b. It is another tool to assist the organization in accomplishing desired objectives - Management Audit questionnaire pinpoint the important problem areas. Thus corrective actions can be taken so that organizational objectives can be achieved with efficiency.

c. Helpful for ailing industries - Management audit is helpful in detecting the problems of such industries and providing the suggestion to improve them. It becomes more important if such industries are to be taken over by government etc.

d. Public sector undertakings - In such PSUs mostly problems occur because of poor management which may be improved by conducting management audits.

v) Organizing Management Audit

a. Devising statement of policy - The policy statement should be quite specific. It should spell out clearly the scope & status of management/ operational auditing within enterprise, its authority to carry out audits, issue reports, make recommendations, and evaluate corrective action.

b. Location of audit function within organization or outside - Some organisations depending upon their size and nature of have established a separate department of audit specialists where the head of the department reports directly to the top executive. In certain cases, the audit group may be a part of the activities of management services department, administrative control department or some other unit of organisation. The greater the independence, greater is the freedom to work effectively.

c. Allocation of personnel - Whatever be the size of the enterprise, it is important that all persons selected & assigned to audit possess a good understanding of auditing theory, a thorough knowledge of fundamentals of both organisation and management, the principles and effective methods of control, and the requirements for conducting scientific appraisal.

d. Staff training program - A continuous training programme is necessary to achieve quality in performing audit assignments because the management auditor must keep abreast of new ways to improve auditing standards. An effective training programme enables staff to assume additional responsibilities and advancements in the organisation.

e. Time and other aspects - The time required to carry out a management audit will vary, depending upon the extent and nature of assignment.

f. Frequency - Management audits should be made often enough to provide protection against growing problems. On the other hand, they should not be so frequent as to lead to repetitious results of questionable value.

vi) Conducting Management Audit

a. Getting facts through interview. **b.** Measuring performance through Management Audit questionnaire. **c.** Concluding it. **d.** Oral recommendation for improvement.

vii) Types of Management Audit Reports: The reporting of results covers a wide spectrum of types. We can describe the more important ones as **follows:**

a. Oral Reports

• In **many situations**, reporting of results will be on an oral basis. This is inevitable since a part of actual audit effort is carried on in conjunction with company personnel.

• It is submitted, if required due to some **emergency**. But it is not considered reliable. However, corrective steps can be taken immediately.

b. Interim written report - In situations where it is deemed advisable to inform management of **significant developments** during the course of the audit, or at least preceding the release of the regular report, there may be some kind of interim written report for their early consideration.

c. Regular written reports

• It refers to formal report submitted at end of work. • The form and content of such written reports will vary widely, both as between individual audit assignments & individual Co's.

d. Summary written report - It is also known as '**Flash' reports**. It summarizes various individual reports. It is submitted to the **top management**. It is prepared on integrated approach. It facilitates **management by exception** because top management has no time to go through those lengthy individual reports.

viii) Organization of written report

a. Format: • Title • Objectives. • Scope. • Findings, conclusions & opinions.

• Recommendations. • Auditee's view. • Summary.

ix) Management Audit Questionnaire

Mfg including Purchasing function	Marketing	Personnel
Manufacturing overview Production planning Production Inventory Purchasing	Marketing overview Sales Market research Advertising Physical Distribution	Personnel overview Manpower planning Industrial Relations

For each of sub heads following points must be mentioned:
• Long-range plans • Short or medium range plans • Organizational structure • Leadership • Communication • Control.

x) Behavioral Aspects In Management Audit - Financial auditor deal with figures, Management auditor with people: • Colleagues in own department. • Staff of auditee department • Top management.

xi) Causes
a. Staff/line conflict: Management Auditors are staff, thus line unhappy.
• **Reasons:** ~ Normally, staff has superiority complex they don't want to understand line, considering it to be inferior. ~ Staff may give irresponsible advice without judging its feasibility. ~ Line doesn't co-operate with staff. ~ Line doesn't provide sufficient information to staff. ~ Line doesn't use advice of staff properly. ~ Staff has faultfinding advice. ~ Staff doesn't consider line before advising.
• **Control:** Auditee fears that his actions will have adverse effect on top management. They have → fear of criticism, → fear of changes and → punitive actions due to - ~ insensitive audit practices and ~ Hostile audit style.
• **Changes:** Resistance to changes. Auditor's recommendation for changes to which auditee resists.

xii) Solution to Behavioral Problems: The following **methods can solve the behavioral problems** frequently encountered in conducting a management audit:
a. Constructive Criticism –
• He should also make obvious in his report the **value of his comments in tangible terms**. Only then would the auditees accept his suggestions and they will feel convinced that the auditor has been objective in his remarks in the report.
• Once the auditor is able to **convince the auditee** that his approach is one of **mutual problem solving** rather than of fault finding, then the chances of auditor's recommendations being considered in an objective fashion would be better.
b. Reporting Methods - The auditor has to make a concerted effort to **convey effectively** his role by adopting a **friendly** but firm tone in his report. It is always possible to disagree without being disagreeable, to criticize without being critical.
c. Participative Approach - Resistance to change is minimal if not absent when participative method is followed. **Proposed recommendations are discussed** with the auditee and such modifications as may be mutually agreed upon are incorporated.
• There should be **right management culture**, enlightened Auditee's & auditors of right caliber
• Management auditor should provide **maximum services** to the auditee organization so as to help them in fulfilling their objectives.
• Auditor should perform his work in a manner so that there is **minimum interference** with regular operations of client.
• Officers should be informed and **review findings** with them before submission of formal

management audit report to top management.
• There should be a **friendly atmosphere** so that the chances of conflict between auditor and auditee can be minimized.

19.3 Operational Audit

i) Meaning - "Operational Audit is undertaken at the instance of management for providing it with information and appraisal of operations and activities."

ii) Types of operational Audit

a. Functional Audits: Functions are means of categorisation of activities of a business. It deals with functions of an organization. Functional audit requires specialization by auditor. For e.g.:- production, payroll.
b. Organisational Audits: To emphasis how efficiently & effectively functions interact.
c. Special Assignment: At the request of Management eg. Causes of ineffective IT system.

iii) Differences between Financial / Operational Auditing

Financial	Operational
Opinion on financial information.	Opinion on effectiveness & efficiency of operation
Only financial information	All activities
Report to shareholders	Report to management
It ends in report	It ends in report including suggestions
By C.A	By team of expert
By independent	May be by in house team
Compulsory	Optional
Yearly	It depends
Old concept	Comparatively new approach

iv) Objectives of Operational Audit

a. Evaluation of performance - During performance evaluation, an operational auditor is dependent upon availability of **acceptable standards**.
b. Appraisal of control - Operational auditing deals with the **administrative controls a**nd its purpose is to determine whether the controls are **adequate**.
c. Appraisal of objectives and plans - If the management policy favours installation of controls, controls should be **as per policy**. Therefore, the basic things that should be evaluated are management policies, plans and objectives.
d. Appraisal of organization structure - Organizational structure provides the line of relationship & delegation of authority & tasks. He should appraise it.
e. Internal Auditing & Operational Auditing
• Internal Auditing is an **independent appraisal activity** within an organization for review of operation as service to organization." Institute of Internal Auditors. N.Y.
• Aforesaid definition **equals** Internal and Operational Audit.
• Operational Audit is **not different** from internal Auditing; it is merely an extension of internal auditing into operational area." Cadmus

19.4 Significance Of Quantitative Ratios In Management And Operational Audit

i) Ratio analysis is a **substantive auditing procedure** designed to obtain evidence as to the completeness, accuracy and validity of the data produced by the accounting system.
ii) It has the merit of bringing to focus the **abnormal deviations** and unexpected variations, which the normal routine checking in auditing may fail to reveal.
iii) Such an assessment is necessary in organizations having **large volume** of transactions and in those organizations following mechanized accounting system where it is not possible to check each and every transaction.

iv) The **objective of management- cum-operational audit** is not only to verify compliance with the normal but also to suggest measures to improve operational environment and thus increase overall productivity.
v) He can use **quantitative ratios & reconciliation** more effectively than financial ratios.
vi) Financial ratios keep changing with the variations in the price level.
vii) Quantitative ratios and reconciliation remain **unaffected by changes in price**. They reflect certain basic relationship and change only if there is a change in the methods of operation, technology, degree of automation, product mix, etc.
viii) Comparison of **quantitative ratios over the years** can reveal pertinent and leading indications of the real state of affairs.
ix) The **various quantitative ratios**, which may be calculated, are input-output ratio for a manufacturing concern, occurrence ratio for hotels, etc. The overall reconciliation statement in case of stocks, membership fee of club, payroll with number of employee's etc. will be very useful and effective.

19.5 Review Of Systems And Procedures: It is required to **improve the methods and to reduce the cost** such as eliminating waste and inefficiencies. The evaluation of a system or procedure actually includes **three separate considerations**:
i) is the system or procedure meeting all of the **current requirements**?
ii) Second, is it operating **effectively**? And
iii) Third, what is the **degree of effectiveness?**

19.6 To determine whether a system or procedure is meeting current requirements, the following among other things, should be considered:
i) is the system or procedure designed to **promote achievement** of the company's **objectives**, and is it accomplished effectively?
ii) Does the system or procedure operate within the **framework of the organizational structure?**
iii) Does the system or procedure ad4quateiy **provide methods of control** in order to obtain maximum performance with the least expenditure of time and effort?
iv) Do the routines designated in the system or procedure **indicates performance** in **logical sequence**?
v) Does the system or procedure provide the **means for effective coordination** between one department and another?
vi) Have all required **functions** been **established**?
vi) Has the necessary authority been designated to carry out responsibilities?
viii) Can any **changes** be made to improve effectiveness?

CASE STUDIES

Q1. A large manufacturing company is suffering from working capital crunch. You as a Management Auditor enlist & discuss the related areas to overcome the company's problem.
Ans: The following action plan may be considered:
(i) Working Capital Estimation: The Company should start by preparing a statement of the projected working capital requirements. This should be based on the functional budgets in sales, production, expenses, capital expenditure and the master budget consisting of projected P&L and the B/S.
(ii) Cash Flow Statement/Cash Budget: Month-wise cash budgets showing inflows and outflows of cash heading-wise should be prepared to analyse the major inflows and outflows affecting the entity.
(iii) Inventory/Stock Management: Raw materials and inventories should be classified properly to determine the level of stock of materials. The method of costing also needs to be looked at minutely. There is a need to establish linkage with the production pattern and

work backwards accounting for time factor in receipt of material. Just in time philosophy will enable the company to reduce processing time, stocks and related costs.
(iv) Credit Management: The Company should lay down a proper policy for evaluating customers, determining the credit period and offering discounts for early payment. An age-wise analysis of debtors should also be prepared so as to avoid credit to defaulters. The company should through its purchase department endeavor to avail the maximum credit period from its creditors. This would enhance the working capital of the company.
(v) Funds Flow Analysis: Company should prepare a funds flow analysis, distinguishing between long-term and short-term sources and applications.
(vi) Investment Management: The idle funds of the company, if any, should be invested in short-term securities to augment the income.
(vii) WIP Analysis: Minimum WIP should be monitored and for the purpose it is necessary to ensure that no bottlenecks develop at any stage during the production process.

Q2. "Operational auditing is not different from internal auditing." Discuss.
Hint Ans: Refer to Point No. 19.3 (iv-e)

Q3. Explain in brief the behavioural aspects encountered in the management audit and state the ways to solve them.
Hint Ans: Refer to Point No. 19.2 (xi) & (xii)

Q4. K Ltd. requires you to organize a Management audit program. Briefly state a plan of action.
Hint Ans: The key requirement for a successful Management audit program would be the approval and support of the top management to initiate. Matters that should be considered are: **Refer** Point No. 19.2 (v)

Q5. RST Ltd, a manufacturing unit does not accept the recommendations for improvements made by the Operational Auditor. Suggest an alternative way to tackle the hostile management.
Hint Ans: While conducting the operational audit the auditor has to come across many irregularities and areas where improvement can be made and therefore he gives his suggestions and recommendations. These suggestions and recommendations for improvements may not be accepted by the hostile managers and in effect there may be cold war between the operational auditor and the managers. This would defeat the very purpose of the operational audit. The Participative Approach comes to the help of the auditor. **Refer** to Point No. 19.2 (xii-c)

QUESTIONS

Q1. State the important aspects to be considered by the External auditor in the evaluation of Internal Audit Function. (4 Marks) **(Nov 2008)**

Q2. XYZ, a manufacturing unit does not accept the recommendations for improvements made by the Operational Auditor. Suggest an alternative way to tackle the hostile management. (5 Marks) **(Nov 2010)**

Q3. General objectives of an operational audit (4 Marks) **(May 2011)**

20. INVESTIGATIONS AND DUE DILIGENCE

20.1 Meaning - Investigation means **systematic and critical examination** of books and record of an entity for specific purpose. For example, it can be undertaken to decide whether to purchase a business enterprise.

20.2 Difference Between Audit And Investigation

Basis	Audit	Investigation
i) Meaning	An audit is independent examination to expressing an opinion on FS.	Investigation implies systematic, critical and special examination of the records of a business for a specific purpose.
ii) Objective	To judge true & Fair View	To establish a fact.
iii) Scope	By law & auditing standards	By terms of engagement.
iv) Period	Yearly	It depends on requirement
v) Nature	General examination	Detailed examination of specific areas
vi) Inherent Limitations	More	Less (because of detailed checking)
viii) Evidences	Persuasive	Conclusive
viii) Reporting	General Purpose Report, which can be used by Stakeholders	Confidential report, generally restricted to few parties
ix) Standards	Standard on Auditing	Standard on Related Services
x) Approach	No doubtful approach	Doubtful approach is adopted.
xi) By whom	Chartered accountant	Expert Team

20.3 Steps In Investigation

An investigation requires the following steps in order of sequence:
i) Determination of objective and establishment of scope of investigation.
ii) Formulation of investigation programme.
iii) Examination and study of various records with reference to appropriate evidence.
iv) Analysis, processing and interpretation of findings
v) Preparation of report and drawing up of conclusions.

20.4 Special Issues In Investigations

i) Selective or 100% Verification - Depends on circumstances. For cash defalcation, 100%)/Profitability (selective basis)
ii) Reliance on Audited Statements - It depends. If doubt in audited statement, then no reliance but for amount of g/w etc., he may rely on FS for selective information.
iii) Experts Opinion - He should obtain the written consent of client before discussing the matter with expert.
iv) Conflicting Claims - He should be objective, professional & Unbiased in his approach.
v) Speculative Opinion – He should provide unambiguous report.
vi) Refusal Being Futuristic - He should not assure users about forecast in a certain way.
vii) Retaining Working Papers - Maintain all important documentation during his work.

20.5 Special Aspects In Connection With Business Investigation

i) Studying the Overall Picture - Figures are only symbols; and it is impossible to interpret them intelligently without knowledge of the background in which they have emerged. He **should study about the organization, industry, the character** of management, the economic and political forces to which the business is subject, the position it enjoys in trade, and economic and financial position of the business.

ii) Profit and Loss Account

Study of profit and loss account should cover profit statements over a period of **5 - 7 years** in order to cover all possible phases of business cycle. This will also enable the accountant to establish a trend between various related elements of profit statement. Study of profit and loss account may be broken down into study of its elements.

a. Turnover: Turnover may be studied as follows:

- Turnover should be **broken** between various products, types of customers, territory etc.
- **Order books** should be examined to identify and eliminate fictitious entries.

b. Wage Structure:

- The **method** of computing wages and rates of wages should be examined.
- Any **unusually high wage** payment should be adjusted.
- In case the business has **suffered labour disturbance** in the past then it should be examined whether a long lasting settlement has been reached.

c. Depreciation:

- Verified whether depreciation has been provided on a **consistent basis** & it is **adequate**.
- If assets **revalued**, depreciation should be provided on revalued amount and over their estimated useful life.
- In case of **leasehold property**, it should be ascertained whether an adequate provision has been made for the deterioration charge that may be payable at the end of lease period.

d. Managerial remuneration -

- It should be verified that remuneration payable is **not excessive** and in-accordance with the provisions of Companies Act, 1956.
- Even if **no or nominal remuneration** has been paid, it should be adjusted.

e. Exceptional and non-recurring Items - These items **disturb the trends** of the profits. The **effect** of these items along with their tax implications should be adjusted.

f. Repairs and Maintenance -

- **Major repairs** and overhauling jobs are generally undertaken at an interval of 3 to 4 years. It should be ensured that these expenses have been systematically **appropriated** over a period of time.
- Repairs expenses should be correctly **classified** into capital and revenue expenses.

g. Unusual year - In order to determine future maintainable profits of the business from the study of past years performance, it is imperative upon the investigating accountant to **eliminate results** of one or more years which vitiated the trend due to exceptional factors.

iii) Balance Sheet - The elements of Balance sheet may be studied as under -

a. Fixed Assets: Fixed assets may be studied as regards with:

- **Age** of fixed assets in order to determine replacements that may be required in future.
- In case **proper repair and maintenance** has not been ensured, a provision, for heavy expenditure on repairs that may be required should be made in the value of the assets.
- If fixed assets **revalued**, depreciation should be provided on revalued amount.

b. Investments:

- Current investments should be valued at **market price**.
- Long term investments should be valued at **cost.** However, a permanent decline in value should be provided.
- **Pre-acquisition profits** should be reduced from cost of investment.

c. Debtors: In assessing their value, the following points should be taken into account:

- The **bad debts** should be adjusted in the year of sale unless the write off is on account of a slump or fall in international prices.
- A study of **credit period allowed** by a business which shows rise in credit period over the period of investigation is indicative of diminishing sales.
- **Age wise** classification of debts helps in understanding the nature of customers and working capital requirement of business.

d. Stock and work in progress:
• These assets should be **consistently valued** as per **GAAP**.
• Due allowance for **damaged, obsolete** and slow moving items should be made.
e. Other liquid assets -These assets include **cash in hand** and readily realizable bank balances. It is prudent to insure cash in hand.
f. Idle assets - Idle assets may be in the form of **unused plant, excessive cash holdings** or obsolete stocks etc. The investigating accountant should ignore these assets from the net worth of the business.
g. Liabilities - The important matter to **investigate** in this regard is whether those are stated **fully or understated or overstated**. In other words, whether the profits of the business have been inflated by suppression of liabilities or there are any free reserves included in the liabilities. In either case, an adjustment would be necessary. Secondly, it should be ascertained that liabilities are not unduly large or are not outstanding for a long time, in such cases, it would be necessary to pay off some of them which would cause a drain on the liquid resources of the concern. The fact should be stated in the report.
h. Taxation:
• It should be verified that adequate **provision for tax** has been made.
• In case there have been **reopening of cases** in the past, the final liability should be ascertained from the order passed by the authority.
• Any **temporary tax benefit** should be disregarded.
i. Capital:
• The investigator should ascertain a proper **balance** between owners and debt capital. A disproportionate ratio can handicap the business.
• Verify that the capital is **reasonable** as compared to fixed assets and working capital.

20.6 Types Of Investigations

i) Investigation under Companies Act, 1956 - Investigation into the affairs of the company can be conducted as per the following provisions of the Companies Act, 1956 -
a. Report by Registrar [Sec 235 (1)] -The registrar is bound to report to CG, the circumstances of the case, if -
• the information or explanation called by him from the company, is not furnished to him.
• After perusal of information of the books and papers, the registrar is of the opinion that -
~ The state of affairs of the company is unsatisfactory; or
~ Full and fair statement of any matter is not disclosed.
Effects of report - On receipt of report, CG may order investigation into affairs of Co.
b. Investigation on opinion of CLB [Sec. 237 (b)]
Opinion of CLB - CLB may forward its opinion to Co. stating that -
• the **business** of Co is being **conducted** with intent to defraud its creditors, members etc.; or for a fraudulent or unlawful purpose; or in a manner oppressive of its members;
• the company was formed for **fraudulent or unlawful** purpose;
• the persons concerned in the formation or management of the company have been **guilty of fraud or misfeasance**;
• the members have **not** been **given all the information** with respect to its affairs which they might reasonably expect.
Opinion of CG - If on perusal of opinion of CLB, CG forms an opinion that the circumstances stated u/s 237(b) exist, CG may order an investigation into the affairs of the company. CG must have **sufficient grounds** to form such an opinion.
c. Investigation on declaration by CLB on application of members [Sec. 235(2)]

Members eligible to make application to CLB	
Company having Share Capital	**Company having No Share Capital**
- 200 members; or - Members holding 1/10 of total voting power.	- 1/5th of total number of members.

Requirements of application - Application to CLB must be supported by such evidence as CLB may require satisfying itself that the applicants have good reason for requiring the investigation (Sec. 236).

Procedure adopted by CLB

• CLB shall give a **show cause notice** to the parties.
• CLB shall consider the **allegations** made in the application; the **evidence** submitted by the applicants; and the **arguments** of the company.
• Then, CLB may declare that an investigation into the affairs of the company is required.

Effect of declaration

• If a declaration is made by CLB that the affairs of the company be investigated, CG shall order an investigation into the affairs of the company.
• Before making the appointment of inspector, CG may demand from applicants, security for payment of costs of investigation (not exceeding Rs. 1,000).

d. Investigation on order of Court — Conditions [Sec. 237 (a)]

• The Court may require that an investigation into the affairs of the company be made. However, the Court shall exercise its powers with great caution, i.e., only if it is satisfied that a **deeper probe** into the company's affairs is desirable.
• **CG shall order** investigation if the Court declares an investigation into the affairs of the company.

e. Special resolution [Sec. 237 (a)] - A company may pass SR requiring the CG to investigate the affairs of the company. Then, CG shall order investigation.

20.7 Powers Of Inspectors (Sec. 239, 240, 240A)

i) Investigate into affairs of 'related companies'*, etc.' (Sec 239) - The inspector can investigate into the affairs of any 'related companies etc.'

***Meaning of 'related companies, etc.' -** Company's subsidiary, Company's holding company, any other subsidiary of Company's holding company A holding company of its subsidiary, A company which is managed by MD or manager of company, A company whose Board is accustomed to act in accordance with directions or instructions of the company or any of its directors, A company which is managed by the company, MD or manager of Co.

ii) Access to books and papers (Sec. 240)

a. Access to books and papers of the company or 'related companies etc.' → Approval of CG is not required.
b. Access to books and papers of any other person → Approval of CG is required.

iii) Retain books and papers (Sec. 240)

a. Period of retention → Maximum 6 months
b. Further rights → after expiry of 6 months, the inspector can again call the books as and when required.
c. Option to the company → The Company may, at anytime, submit the certified copies of the books and get back the original books.

iv) Seize books and papers (Sec. 240A)

a. The inspector can make an **application to the Magistrate** of First Class or Presidency Magistrate if he has reasonable ground to believe that the books and papers may be destroyed, mutilated, altered, falsified or secreted.
b. The Magistrate **may authorize** the inspector to seize such books and papers as the inspector considers necessary.
c. The inspector may **retain** the books and papers till conclusion of investigation.

v) Examine on oath (Sec. 240)

Examination of officer, employee or agent of the company or 'related companies etc.' → Approval of CG is not required.
Examination of officer, employee or agent of any other company → Approval of CG is required.

vi) Take notes on examination (Sec. 240) - Notes shall be: Made in writing, Read over to the person examined, Signed by the person examined, and Used as evidence in legal proceedings.

20.8 Inspectors' Report (Sec. 241)

i) Report to CG

Interim Report - Mandatory only if ordered by CG.

Final Report - is mandatory for the inspector to make the final report.

ii) Obligations of CG to forward report

Mandatory – To Company, 'Related companies etc.', Court, Members who had applied to CLB for investigation u/s 235(2) at their request.

Optional to Any member or creditor of Co, any member or creditor of the related company

iii) Publication of the report - CG has option to publish report in manner it deems fit.

iv) Effect of the report - Inspectors' report may be used as evidence in legal proceedings.

20.9 Action By CG (Sec. 242, 243 and 244)

i) Prosecution (Sec. 242) - If a person is criminally liable for an offence, CG may bring prosecution against him.

ii) Application u/s 433, 397, 398 (Sec. 243)

a. CG may present a petition to the Court for winding up the co. on just & equitable ground.

b. CG may make an application to CLB for an order u/s 397 and 398.

iii) Recovery proceedings (Sec.244) - CG may institute proceedings for:

a. recovery of damages in respect of fraud, misfeasance etc. in connection with promotion, formation or management.

b. recovery of property of the company which has been misapplied by any person.

iv) Indemnity to the company - CG shall indemnify company for any loss caused to Co.

v) Proceedings u/s 203 - CG may bring proceedings u/s 203 against delinquent directors and fraudulent persons.

20.10 Investigation Of Ownership Of A Company (Sec. 247)

i) When can CG order investigation?

a. CG may **suo motu** order investigation

b. If **CLB** makes a **reference** to CG for investigation, CG shall order investigation

c. If a complaint (**supported by evidence**) is made to CG, CG may order investigation.

ii) Purpose of investigation - To determine the true persons -

a. who are **financially interested** in the success or failure of the company; or

b. who are able to **control or materially influence** the policy of the company.

iii) Scope of investigation - CG may specify -

a. Scope of investigation

b. Matters to be investigated

c. Period, to which investigation shall relate.

iv) Powers of inspectors - The powers of inspectors may be **limited** to matters connected with particular shares or debentures.

v) Investigation procedure - Following provisions shall apply with modifications:

a. Sec. 239 (Investigation of affairs of 'related companies etc.')

b. Sec. 240 (Production of documents and evidence)

c. Sec. 241 (Inspectors' report).

vi) Copy of report - CG is not bound to furnish report to the Co. or any other person if -

a. CG is of opinion that there are **good reasons** for not disclosing contents of the report;

b. a **copy** of the report is kept with the registrar.

vii) Investigation expenses

a. The expenses of investigation shall be paid by **CG**.

b. CG may **recover** these expenses from the **complainants**

20.11 Imposition Of Restrictions On Shares Or Debentures (Sec. 250)

i) Power to impose the restrictions - CLB is empowered to impose restrictions on shares or debentures. CLB may pass an order imposing the restrictions only when -
a. a reference is made by **CO**; or **b.** a **complaint** is made by any **other person**.

ii) Nature of restrictions

a. Unissued shares	- shall not be issued
b. young right on shares	- shall not be exercised
c. Transfer of shares	- shall be void
d. Right shares	- shall not be issued
e. Payment of dividend	- shall not be made
f. Repayment of capital	- shall not be made

iii) Period of restrictions - Restrictions can be imposed for a maximum period of **3 yrs.**

iv) Conditions for imposing restrictions - CLB must be satisfied that -
a. there is **good reason** to find out the relevant facts about any shares; and
b. such facts cannot be found out unless certain restrictions are imposed on shares.

v) Variation of order - CLB may, at anytime, **vary or rescind** any order made by it.

20.12 Investigation On Behalf Of Incoming Partner

i) Main Purpose - The incoming partner is interested in judging whether the **terms and conditions** offered to him are reasonable.

ii) Considerations by investigator
a. First of all, he should ascertain the **reasons for offer** of admission to a new partner.
b. Then he should study the **history and growth** pattern of the firm.
c. He should study FS of previous 3-5 years to determine its **profitability** in past years.
d. Compare the **rate of return** in the said firm with common rate **of** return in the said field.
e. He should also examine **assets and liability** position of the firm.
f. He should pay proper attention to any **hidden liability or overvalued asset.**
g. Investigator should carefully study the provisions of the **partnership deed**.
h. Special attention should be given to some specific points w.r.t. partnerships, such **as profit sharing ratio,** interest on capital etc.
i. Manner of computation of **goodwill** retirement of a partner should be ascertained.
j. The **reputation** of the firm as well as that of partners should be properly ascertained.
k. He should study the quality i.e. **skill and competence** of **key management** personnel.
l. He should study the important **contracts** etc. For example, any lease contract entered into by the partnership firm.

20.13 Investigation On Behalf Of Bank Proposing To Advance Loan To A Company

i) Main Purpose - Whenever a prospective borrower approaches the bank for loan, the bank is primarily interested in knowing -
a. the **purpose** for which a loan is required.
b. the **source** from which it would be repaid; and
c. the **security** offered by the borrower

ii) Investigator should obtain knowledge on
a. The **loan proposal** submitted by borrower.
b. The **purpose** for which the loan is required and its repayment schedule.
c. The **creditworthiness** and reputation of the board of directors.
d. The **MOA or AOA** of company to assure that it is in fact empowered to borrow money.
e. The **historical background** and growth trend of the company during the past years.
f. Other **loan obligations** to check whether company is regular in paying installments.
g. The **growth and profit prospects** of company considering present economic scenario.

iii) Examination of Profitability and state of affairs
a. The investigating accountant should prepare a **condensed income statement** from the P&L account for the previous **five years** so that it can be ascertained whether the company

has strong past as far as profitability is concerned.
b. Moreover, he should compute **profitability** and **financial ratios** such as Debt equity and **current ratios** so that overall position of the company can be judged.
c. The investigator should also study the **cash flow statements** of the company to decide whether there has been consistent cash flow from the operating activities.
d. He should study various items of **balance sheet**. **Assets** are examined to ensure their existence, ownership and proper valuation. Special attention should be given to possibility of their overvaluation in the FS intentionally to show strong financial position. It should also be ascertained that various assets are properly insured.
e. Liabilities should be ascertained to ensure company's present and future obligations. It should also be examined whether all liabilities have been included by the management.
f. He can devise **projected statements** so that recoverability of loan can be judged.

20.14 Investigation Of Frauds

i) Cash Receipts

a. First of all **different sources**, from which income is generated, should be ascertained.
b. It should be ascertained whether income from **all sources is accounted** or not.
c. Income from **small or negligible source** like sale of old newspaper should be carefully examined as chances of manipulation in such accounts are high.
d. Copies of receipts should be carefully checked.
e. Receipts from customers should also be properly examined.
f. Unreasonable cash discounts shown in the books should be properly enquired into.
g. It should also be ensured that receipts are **serially numbered** and all receipts have been accounted for.
h. In case of any **cancelled receipt**, its original copy should be properly scrutinized.

ii) Cash Payments

a. Internal Controls on cash payment should be carefully examined to ensure that all payments are properly authorized by competent authority.
b. Acknowledgement for payment should be **matched** against the bill raised by party.
c. Payments by **bearer cheque** can be manipulated, such payments should be examined.
d. Small payments such as patty cash expenditure should be thoroughly examined.
e. Any **unusual payment** such as exceptional rise in traveling expenses as compared to that of precious year should be further inquired into.
f. Possibility of fake payment to **dummy workmen** is particularly high in some industries. Investigator should examine IC over this area such as biometric entry.
g. Alterations made in **payment records** should also be carefully examined.
h. Payments to **related parties** should be enquired as possibility of manipulations is high.

iii) Balance in customers Ledger

a. Trace the entries in **order book** with the corresponding record in sales daybook.
b. Examine **customer's a/c** to ensure that they have been properly debited appropriate.
c. The amounts written off as **bad debt** should be carefully examined.
d. Any **unusual discounts** given to them should be thoroughly enquired into and written representation should be obtained from appropriate authority in this connection.
e. Attention should be given to the teeming and lading **frauds** in such accounts.
f. Balance confirmation from customers should be obtained.

iv) Balance in suppliers Ledger

a. Goods **inwards book** should be examined w.r.t. entries made in supplier's account.
b. Examine that **credits** have been raised in respect of actual goods received.
c. Carefully examine whether **rebates given** have been appropriately adjusted or not.

d. Special attention should be given to such accounts where supplier is a **related party**.
e. Balance confirmation from them should be obtained to confirm amount due to them.

v) Stock Defalcation
a. Confirm whether there is strict **internal controls** over receipt, issue & storage of stock.
b. There should be stringent controls w.r.t. **high value stock**.
c. The honesty and ethical values of **persons in charge** of stores should be inquired into because generally fraud in stores is possible through collusion among employees.
d. Investigator should carefully go through the various records relating to inventories.
e. He should **physically check** quantities and reconcile them with those shown in records.
f. Any **shortages** observed therein should be further investigated.
g. Small items of inventories should be examined to rule out the possibility of pilferages.

20.15 Investigation For Receipt Of Royalty

i) 'Royalty' is a term which is most commonly used in case of **publication** of some literary work wherein it is payable to the author from publisher.
ii) Moreover, this Term is also used in case of:
a. Mines wherein royalty is received by owner of mine &
b. Patents wherein owner of patent receives royalty from the users.
iii) In case of Royalty received, the investigator should carefully study the various provisions of **agreement** between author and publisher specially the following:
a. The **rate** at which royalty is receivable.
b. Computed on print price or discounted price at which copies are sold to retailers'
c. Whether any royalty is receivable on copies distributed as **free sample** etc.
iv) The investigator should obtain **records of books published** / Printed during the year, Opening stock & closing stock of books.
v) He should also **physically verify** the stock of books at the end.
vi) Investigator should carefully examine the **computation made** w.r.t royalty to ensure that the amount has been arrived at properly.
vii) In case of mines, Examine the **records of extraction**, E.g.: Quantity of coal extracted.
viii) In case of patents, Examine the **units produced** at user's end and check whether royalty has been computed w.r.t. total units manufactured/ Produced during the year.

20.16 Due Diligence

i) Meaning
a. This term is used in relation to **corporate restructuring**.
b. 'Corporate restructuring' includes internal reconstruction, amalgamations, mergers, JV.
c. However, Corporate restructuring involving **more than one party** should be **planned properly**. Thus, in such cases, due diligence is conducted.
d. It is performed to check whether it is **feasible and desirable** to acquire/merge the unit.

ii) Components of D.D. - Discipline-wise it can be classified as follows:
a. Commercial / Operational Due Diligence: i.e. to check whether the target is commercially feasible.
b. Financial Due Diligence: To check the financial feasibility of the target by examining the FS and devising their profit trends.
c. Tax Due Diligence (Direct and Indirect): Whether the target is paying appropriate taxes on a regular basis. Moreover, ascertain what the tax benefits available to target are.
d. Information System Due Diligence: Whether information system of target is providing right information to the right management at the right time in the right quantity.
e. Legal Due Diligence: Whether target is complying with all applicable laws & regulations.
f. Environmental Due Diligence: To check the compliance of target with environmentally related rules and regulations.

g. Personnel Due Diligence: To ascertain whether the employees of target company are competent and efficient.

20.17 Financial Due Diligence

i) Relation with other D.D - Sometimes, the financial due diligence is interpreted as Complete Due diligence, since it is supposed to ascertain the financial implication of all other Due Diligence. This is however not appropriate. It is less than over all Due Diligence review.

ii) Coverage -

a) Brief History of Target and Background of its Promoters - The author should begin the financial due diligence by looking into the history of the company and background of its promoters. The following points should be considered by the auditor:

- How the company was **set-up** and who the promoters were;
- **Market share** enjoyed by the target in past and change therein;
- **Any regulatory requirement** in past that may have impact on business of the target.
- Enquiry about **history of target's business,** product, expenses, suppliers, markets, etc.

b. Accounting Policies - Consider the following points in relation to Accounting Policies:

- **What** Accounting Policies are followed by the target.
- Whether Accounting Policies **followed** by the target are **appropriate.**
- Consider the effects of the recent **changes** in Accounting Policies.
- Whether target has **not changed** Accounting Policies with an intention to sell itself.
- The **areas** in which **Accounting Policies followed** by the target and the acquiring enterprises **are different** and **impact of such difference.**

c. Review of FS - The following points should be considered:

- Whether the FS is prepared in accordance with relevant **Financial reporting framework** required for preparation and presentation of FS.
- Review the **operating result** of the target in detail, as the price of the target is largely based upon its operating results.
- Consider the presence of any **extra-ordinary item** of income or expenses that might have affect the operating results.
- Compare the **actual figures** with the **budgeted figures.**
- Consider the **basis** on which assets have been valued & liabilities have been recognized.
- Check whether the **net worth** of the business has been arrived by taking into account the impact of over / under valuation of assets and liabilities.
- Pay particular attention to the valuation of **Intangible assets.**
- Look specifically for any **hidden liabilities** or **overvalued assets.**

d. Taxation - He should consider the following points in relation to taxation:

- Whether company is **regular in paying** various taxis to the Government.
- Whether **registration** of the enterprises has been made **under the various tax laws.**
- Consider the **tax effects** of the merger or acquisition.
- Verify whether any **tax holiday** is available to the target.

e. Cash Flow - He should review the cash generating abilities of the target company by considering the following points:

- Whether the company is able to meet its **cash requirement** through internal sources or it has to seek external help.
- Whether the company is **able to honor its commitments** with its creditors, bank, Government, Stake-holders, etc.
- If the company is **able to generate cash** from its debtors on a timely basis.
- Whether any **fund lying idle** with the company.
- Whether company is **reaping more benefits** out of the available funds.

f. Financial Projections - The following points should be considered:

- The auditor should obtain the **projection of next 5 years** from the target company.
- He should ask them to give projections on **optimistic, pessimistic** & **most likely basis.**

• Evaluate the **assumptions** used in preparation of financial projection.
• Mention in the report if auditor feels that the **projections** provided by the target are **not achievable or aggressive.**

g. Management and Employees - In his regard, he should consider the following points:
• Check whether all the **Employee benefits** like P.F., ESI, Gratuity leave encashment, etc. have been **properly paid or provided.**
• Consider whether the **assumption** regarding increase in salaries etc. are reasonable.
• Consider whether all the **eligible employees** have been covered for PF, ESI, etc
• Check whether the **pay packages** of the key employees are appropriate or need to be revised in near future.
• Identify those **key employees who will not continue** after the acquisition.

h. Statutory Compliance - This is the aspect that the auditor should investigate in detail:
• Make a **list of the various laws** that are applicable to the entity.
• Check whether Co. is liable for any **punitive charges** for non-compliance of such laws.

20.18 Contents Of Due Diligence Report

Executive Summary	Comments on properties, terms of leases, lien & encumbrances.
Introduction	Assessment of taxation and statutory liabilities
Background of Target	Assessment of possible liabilities on account of litigation and legal proceedings against the company.
Objective of due diligence	Interlocking investments & financial obligations with group / associates companies, amounts receivables subject to litigation, any other likely liability which is not provided for in the books of account.
Terms of reference and scope of verification	
Brief history of company	Assessment of net worth
Share holding pattern	Assessment of operating results
Observations on review	SWOT ANALYSIS Comments on future projections
Assessment of management structure	Status of charges, liens, mortgages, assets & properties of the company.
Assessment of financial liabilities	Suggestion on ways and means to cover unforeseen and undetected contingent liabilities
Assessment of valuation of assets	Suggestions on various aspects after the proposed merger/acquisition.

CASE STUDIES

Q1. S wants to join PQR Ltd, a partnership firm as 25% sharing partner. Advice X, what important steps he should take while conducting Investigation on behalf of S as an Incoming Partner?
Hint Ans: Refer to Point No. 20.13

Q2. Mr. Manak is above 80 years old and wishes to sell his proprietary business of manufacture of specialty chemicals. S Ltd. wants to buy the business and appoints you to carry out a due diligence audit to decide whether it would be worthwhile to acquire the business. What procedures you would adopt before you could render any advice to S Ltd.?
Hint Ans: Refer to Point No. 20.17 (ii)

Q3. A company engaged in manufacturing of chemicals is consistently recording higher sales turnover, but declining net profits since the last 5 years. As an investigator appointed to find out the reasons for the same, what are the points you would verify?
Ans: It may be attributed to one or more following reasons requiring further investigation:

(i) Unfavourable Sales mix: Where the company sells different chemical products with different product margins, the product with the maximum PV ratio/margin should have a higher share in the total sales. If due to revision of sales mix, more quantities of unprofitable products are sold, profits will be reduced in spite of an increase in sales.
(ii) Negative Impact of Financial Leverage: Where the company does not have sufficient own funds (equity) but has a higher debt-equity ratio, the interest commitments will be higher. As the volume of its operation increases, higher debt and interest charges would result in lower profits.
(iii) Other Items Included in Sales: The figure of sales as per Profit and Loss Account may include incidental revenues, e.g., freight, excise duty, sales-tax, etc. where the amount of excise duty goes up considerably the total sales may show an increase which is not represented by a real increase in sales quantity/value.
(iv) High Administrative and Selling Expenses: Administrative and selling costs are generally period costs which are fixed in nature. Their increase is generally not proportional to sale increase. However, a reduction in profit could also be due to increase in administrative overheads and sales overheads at a rate higher than the rate of increase in sales.
(v) Cost-Price Relationship: If the increase in cost of raw materials and labour has not been compensated by a corresponding increase in the sales price this would also result in higher sales and declining profits. In spite of same sales quantity, for the increasing cost of raw materials and other services, per unit values of the product has been increased which is however unmatched by the increase in cost.
(vi) Competitive Price: Where sales have been made at cut-throat prices in order to eliminate competition from the market, the profits would be in the declining trend in the short-run.
(vii) Additions to Fixed Assets: Where there are heavy additions to fixed assets and consequent depreciation charges in the initial years of additions, there may be reduction in profits in spite of increased sales.

Q4. State the major Steps involved in the verification of assets and liabilities included in the Balance Sheet of the borrower company which has been furnished to the Bank
Hint Ans: Refer to Point No. 20.5 (iii)

QUESTIONS

Q1. Your client is contemplating taking over a manufacturing concern and desires that in the course of due diligence review, you should look for hidden liabilities and overvalued assets, if any. State in brief the major areas you would examine. (5 Marks) **(Nov 2010)**

21. PEER REVIEW

21.1 Meaning
i) The term **"peer"** means a person of similar standing.
ii) The term **"review"** means retrospective evaluation of the subject matter.
iii) "**Peer Review**" means an examination and review of the systems and procedures to ensure whether they have been put in place by the practice unit for ensuring the quality of attestation services.
iv) The review is carried out by a "**reviewer**", i.e., a member, selected from a panel of reviewers maintained by the Board.
v) The term "**practice unit**" means members in practice, whether practicing individually or as a firm of Chartered Accountants.

21.2 Objective
i) To ensure that members while performing attestation services comply with **technical standards** laid down by the Institute;
ii) To ensure that such a member has in place **proper system** for maintaining the quality of attestation services performed by him;
iii) To ensure compliance with **statutory and other regulatory** requirements; and
iv) To **enhance the reliance** placed by the users of FS.
The **key objective** of peer review exercise is to **identify weaknesses** that are pervasive and chronic in nature.

21.3 Qualifications Of Reviewer - The Peer review board would maintain a panel of reviewers. To be a panel member, an individual should be:
i) a member of ICAI;
ii) possessing at least 15 years experience of audit; and
iii) currently active in the practice of accounting and auditing.

21.4 Peer Review Process - The Peer Review process has three stages - planning, execution and reporting.
i) Stage 1 - Planning
a. Empanelment of Reviewers: The reviewer should be **member** of ICAI having at least **10 years** cumulative audit experience & currently in **practice**.
b. Intimation to practice unit: PU is intimated in writing, about its selection for peer review. Along with this, a panel of **3 reviewers** & a copy of the **questionnaire** are also sent by Peer Review Board (PRB).
c. Initial communication by PU: PU intimates its **choice** of reviewer to board within 15 days from receipt of information. Within 1 month of receipt of intimation, PU send completed questionnaire to reviewer along with complete list of client.
d. Selection of sample attestation service engagement: Selection on **Random basis** for review
e. Confirmation of visit: The reviewer, in consultation with the practice unit, is required to **fix the date**(s) for onsite review in a manner so that the peer review process is completed **within four months** of the receipt of intimation.

ii) Stage II – Execution - The execution stage involves the **actual conduct** of review and, thus, begins with initial meeting and ends with review of records by the reviewer.
a. Initial meeting: Between reviewer & PU to confirm the **accuracy of responses** to the questionnaire,
b. Compliance Review: That is independence, maintenance of **professional skills and standard**, consultation, staff selection & supervision and office administration to understand working and control procedures of PU.

c. Selection of Attestation services Engagements: He may **modify** his initial sample selected for review in consultation with the PU at executions stage.
d. Review of Records: Compliance & substantive approach: Compliance procedures are conducted to know worthwhileness of **Internal Controls** at PU.
Then he decides whether to rely on them or not. In case of reliance, his NTE of substantive procedure will be less extensive & vice-versa. However, Compliance procedures are not necessary if size of firm is small/ medium. He may adopt only substantive procedure.

iii) Stage III – Reporting
a. Preliminary Report of Reviewer: At the end of review, preliminary report is sent to PU (before any report to Board) in case its system & procedure found to be deficient or where **non-compliance** has been noticed. No preliminary report otherwise. Report should be on the latter head. It should contain date and reviewer's signature, membership no. & reviewers code no. However in preliminary report, there should not be any reference of the name of any individual from PU.
b. Reply to Preliminary Report: PU is required to reply in writing, within **21 days** from receipt of the preliminary report from reviewers.
c. Interim Report of Reviewer: If reviewer is **not satisfied** with reply, then he sends interim report to Board. The Board recommends to PU & instructs the reviewer to carry out **review again after 6 months** to verify whether systems & procedures have been modified appropriately.
d. Final Report of Reviews: It is sent to PRB if reviewer is satisfied with reply of PU report should **incorporate findings**.

21.5 Peer Review Board
i) The Council of the ICAI in **March 2002** established the Peer Review Board'.
ii) The Board shall consist of maximum of **11 members** to be appointed by the Council, of whom **at least 6** shall be from amongst the **Members of the Council**.
iii) The **balance members** of the Board shall he drawn from amongst prominent individuals of high integrity and reputation, such as former public officials, regulatory authorities, bankers, senior professional chartered accountants, security industry executives, educators, economists and business executives.
iv) The **Chairman and Vice-Chairman** is appointed by Council from amongst the members of the Council.
v) At least **2/3rd** of Council members on the Board shall hold Certificate of Practice
vi) Casual vacancies on the Board shall be filled in by the council
vii) The term of a member shall be for **one year** or such period as may be prescribed by the Council

21.6 Qualified Assistant - The reviewer may take the help of a qualified assistant while carrying out peer review.
i) Only one assistant who shall be a **chartered accountant**
ii) The **name** of the qualified shall be intimated to the Board as well as the practice unit before the commencement of the peer review
iii) He shall also have to **sign** the declaration of **confidentiality**
iv) He shall be from the firm of the reviewer and should have been **working** with reviewer for at least **one** year as a member in practice.

21.7 Approach Of The Reviewer
i) The reviewer should gain an **understanding of the engagement letter**. Engagement letter defines the nature and scope of the attestation engagement and practice unit's responsibilities with regard to the engagement. This understanding would help him in planning the review of documentation.

ii) The **number of attestation engagements** to be selected requires the exercise of **judgment** by the reviewer based on the evaluation of replies given in the questionnaire and the size of the practice unit.
iii) The reviewer should **enquire** from the PU about **policies and procedures for accepting** particular engagement.
iv) The reviewer may follow a combination of **compliance procedures and substantive procedures** throughout the peer review process.
v) Finally, the reviewer while **evaluating** records may determine that:
a. any **significant issues** that arose during the course of the engagement have been appropriately considered, resolved and documented;
b. adequate **audit evidence** is obtained to support the reasonableness of the conclusions drawn; and
c. significant decisions relating to the engagement have been properly documented.

21.8 Inherent Limitations Of Review
i) The review would **not** necessarily **disclose** all weaknesses.
ii) As there are inherent limitations in the effectiveness of any system of quality control, **departure from the system** may occur and may **not be detected**.

21.9 Review Procedures: A reviewer, based on the information and explanation obtained during the course of review, has to assess the evidence obtained and formulate his opinion on the compliance with technical standards and the internal controls within the practice unit that contribute towards maintenance of the quality of reporting.
i) Off-Site Procedures -
a. The reviewer would **start procedures** as soon as response of the practice unit to the questionnaire is received.
b. The reviewer should **examine the response** given by the practice unit.
c. This examination is done to determine **initial sample of the clients** to whom attestation services have rendered; and to obtain basic understanding of quality control policies and procedures of PU.
d. Thus, the reviewer would be able to conduct the **review** in an effective, efficient and timely manner.

ii) On-Site Procedures –
a. The on-site procedures would begin with the **initial meeting** with the practice unit.
b. Reviewer must **fix the date(s)** for on-site review in consultation with the practice unit.
c. While flexibility is built-in in this process, reviewer must fix-up date by **mutual consent.**
d. The **primary purpose** of the initial meeting with the practice unit is to determine the accuracy of the responses.
e. After establishing the accuracy of the responses, the reviewer should be able to have a thorough **understanding of the policies and procedures** followed by the practice unit.
f. The reviewer's next task is to perform **compliance testing** or compliance review.
g. Compliance review is conducted to **evaluate control procedures**.
h. Then the reviewer applies **substantive procedures.**

iii) Compliance Review Procedures –
a. It is the first stage of applying review procedures to **ascertain** whether the practice unit has been **observing the systems** as contemplated by it in the questionnaire.
b. The Statement requires reviewer to **consider the** '**general controls'** which comprise of five controls, viz., Independence, Maintenance of Professional Skills and Standards, Outside Consultation, Staff Supervision and Development and Office Administration.
c. A **checklist** which is illustrative in nature for the guidance of reviewers is given under:

• **Independence** -
~ Does he practice unit have a policy to ensure independence, objectivity and integrity, on the part of partners and staff? Who is responsible for this policy?
~ Does the practice unit communicate these policies and the expected standards of professional behavior to all staff?
~ Does the practice unit monitor compliance with policies and procedures relating to independence?
~ Does the practice unit periodically review the practice unit's association with clients to ensure objectivity and independence?
• **Professional Skills and Standards-**
~ Does the practice unit have an established plan for personnel needs at all levels, based on current and anticipated clientele, business growth, impending retirements, etc.?
~ Does the practice unit have an established recruitment policy?
~ Are applicants and new personnel informed of the personnel policies and procedures relevant to them?
~ Does the practice unit have continuing education programmes for partners and staff?
~ How easily are current & relevant professional literature, including accounting & auditing standards and pronouncements by professional bodies, available to partners and staff?
~ Does the practice unit conduct programmes for developing expertise in specialized areas and industries?
• **Outside Consultation** -
~ Is there any policy for consulting experts (both internal and external)?
~ Has the practice unit built up a network of other accountants, solicitors and advocates, and technical consultants in industries in which its clients operate?
• **Staff Supervision and Development** -
~ Does the practice unit have written guidelines on the responsibility at each level, and on the expected performance and qualifications necessary for advancement o the next level?
~ Does the practice unit have a system for gathering and evaluating information on the performance of personnel?
~ Does the practice unit have a system of periodically counseling personnel on performance and career opportunities?
~ Does the practice unit have a system of assigning an audit to the most appropriate personnel? Are requirements of specialized expertise and personnel skills given due consideration?
~ Does the practice unit have written guidelines for maintaining working papers (form and content)?
~ Does the practice unit have standardized forms, checklists, and questionnaires to assist in the conduct of audit?
• **Office Administration -**
~ Does the practice unit have established procedures for record retention, including security aspects?
~ Does the practice unit maintain a record containing particulars such as client name, nature of engagement, particulars regarding date of commencement of audit, date of audit report, billing, etc?
~ Does the practice unit maintain staffs register?
~ Does the office have a proper library containing relevant books and all publications of ICAI?

iv) Review of Records - Compliance/Substantive Review Procedures –
a. After evaluating general controls by performing compliance procedures, the Statement envisages that a reviewer should actually **review the records** of the practice unit.
b. Such review may either be conducted by **compliance approach or substantive approach** or a combination of both.

c. At the first stage, the **records** in respect of **following key controls** are to be reviewed to ensure compliance with technical standards:
• Audit Record Administration
• FS Presentation
• Review and Evaluation of System of Internal controls
• Substantive Tests
• Audit Conclusion
• Audit Report

Illustrative Checklist of Audit Programme of a Reviewee - A checklist which illustrates the contents of the audit programme of a reviewee for the guidance of the reviewer is given hereunder:
• Appointment and the relevant resolution about the appointment
• Terms of the engagement including reports required and manner of determining audit fees.
• System of book-keeping and the list of the books of accounts maintained by the entity
• Particulars of the promoters, directors and their powers
• Names of persons who write the books of accounts and other authorised officers
• Memorandum and Articles of Association, Partnership Deed as applicable
• Details of business of client and its accounting systems by reviewing and assessing information on:
~ Nature of business of the entity; and
~ The internal control system including owner/manager controls.
• P&L A/C, balance sheet, auditor's and directors' reports of the previous year and the reports of internal auditor.
• Analytical review procedures in order to:
~ identify areas of accounts which are important because of their size;
~ highlight unusual or unexpected figures or relationships in the accounts;
~ Design audit test which concentrates on important and unusual items; and
~ obtain sufficient audit assurance to allow the reduction or even elimination of detailed testing in some areas.
• Assessment of audit risk by using the professional judgement and audit procedures to ensure that it is reduced to an acceptably low level
• Preliminary estimates of materiality for the audit as a whole
• Class of accounting transactions which are relevant & to decide type of testing & samples
• Selection of representative samples
• Compliance tests to evaluate the reliability of key controls
• Material weaknesses in the operation of key controls to management
• Performance of analytical review procedures, substantive tests of detail to obtain sufficient, relevant and reliable audit evidence for each audit objective.
• Fundamental accounting assumptions i.e., consistency, going concern and accrual basis of accounting are followed by the client in the preparation and presentation of FS.
• Any change in an accounting policy which has a material effect has been disclosed.
• Audit report is received from all the Branch Auditors and any reservation made by the branch auditor is appropriately dealt with in the finalisation of accounts.
• Working papers contain all audit evidence, and are cross-referenced.
• Summary of work done, problems, important judgements and audit conclusions
• Review by senior incharge of work of all assistants, audit programme followed and work performed as per time schedule.
• Permanent file updated throughout the audit.
• Review of unadjusted errors to determine whether individual effect is material.
• Compliance with Companies Act, 1956 and other relevant statutory requirements
• Compliance of all mandatory Accounting Standards issued by the Institute

• Post balance sheet events.
• Formulation of draft audit opinion.
• Comparison of budgeted time to actual and reasons for major variations.
• Complete staff evaluation forms.
• Planning of next year's audit and including it in the permanent audit file.
Finally, the reviewer may decide to employ substantive procedure only in case he is unable to place reliance in specific control procedures. The application of substantive review procedures would involve inspection of working papers of the attestation engagement.

v) Quality of Reporting –
a. The reviewer should verify whether the **reports** issued by PU are **supported by conclusions** reached at each stage of audit.
b. The reviewer should determine **level of supervision** of engagement under review.
c. The **working papers** must contain adequate evidence to support the audit opinion.
d. The reviewer should ascertain that **principles** relating to manner of qualifying 'the audit report have been complied.

vi) Office Systems and Procedures - The reviewer should focus on it that an **assistant** is wasting time on non-essentials. Again, a senior may lose control by failing to compare the schedule with the complete item of work.

vii) Training and Office Administration - The training programme of the **articled/audit clerk** is a significant component to ensure the availability of a proper manpower.

viii) Time Budget - The **partner must control** it firmly, as assistants are generally liable to take up more time than originally scheduled. While designing the **training programme** of **articled/audit** clerks, the practice unit should consider the following elements:
a. Assigning **progressive work experience** commensurate with the expanding abilities of the trainees.
b. Designing a **study plan** to ensure that trainees are fully prepared to take examinations at the earliest opportunity for which they are eligible.
c. Ensuring that **work experience** is preceded and backed by practical instructions, including briefing before each assignment to ensure that the application of practical techniques to the circumstances of individual clients is properly understood.
d. Ensuring in-house **theoretical training** is integrated with practical work experience.
e. Assigning higher levels of **technical and supervisory responsibility** and client contact designed to ensure that personal and managerial skills are developed.
f. Ensuring **professional attitude** & understanding of professional ethics are developed.

21.10 Compliance With Technical Standards
i) Accounting Standards issued by the ICAI;
ii) Auditing and Assurance Standards issued by the ICAI;
iii) Framework for the Preparation and Presentation of FS and Framework of Statements on Standard Auditing Practices and **Guidance Notes** on related Services issued by the ICAI;
iv) Statements issued by the ICAI;
v) Guidance Notes issued by the ICAI:
vi) Notification /Directions issued by the ICAI; and
vii) Compliance of the provisions of the various relevant **Statutes and/or Regulations** which are applicable in the context of the specific engagement being reviewed.

21.11 Staffing - In this context, the following may be noted:
i) The practice unit should have laid down **qualifications deemed necessary** for various levels of responsibility. This is to ensure that the firm is staffed by personnel who have

attained and maintain the Technical Standards and professional competence required, to enable them to fulfill their responsibilities with due care.
ii) There should be **introductory procedures** for the new employees like orientation programme, discussion of office procedures, etc.
iii) the **performance** of each staff should be **evaluated** and communicated to the staff on periodical basis and should be filed in the staff file.

• **Professional Development of Staff -** All big or medium size practice units or progressive small practice units should have system of continuous professional development of its staff:
~ Laid down **policies and procedures** of practice unit relating to independence & system to communicate them to the staff at the time of joining and subsequently on periodic basis.
~ In-house mechanism for continuous **professional development education**.
~ Provide access to **libraries** and other authoritative sources to its staff; provide copies of Technical material issued by the Institute, from time to time, thereby ensuring that they are aware of changes taking place in Accounting and Auditing and Assurance Standards.
~ Designating **expert/experienced individuals** for consultation & their area of expertise.

21.12 Developments In The Field Of Peer Review

Recently the **American Institute of certified Public Accountants** (AICPA) has constituted a **task Force** which has recommended the following to enhance transparency and effectiveness of the Peer Review:
i) Peer review **reports** should be as concise as possible and written in **"Plain English."**
ii) The peer review should be made more **transparent** by communicating the objectives, procedures, and results of oversight to the public.
iii) To ensure a **level playing field** for all practitioners, all state boards of accountancy should require peer review as a condition of licensure.
iv) The AICPA should conduct a **comprehensive peer reviewer recruitment campaign** to attract new, quality peer reviewers and to educate firms on the benefits of having its owners and staff members involved in performing peer reviews.
v) The AICPA's Peer Review Board should **continue to ensure the high quality** of peer reviewers, establishing additional minimum requirements to be a peer reviewer, and consider requiring additional minimum criteria such as the number of accounting and auditing hours spent by a reviewer in his or her own firm.
vi) The AICPA should provide a **mechanism** for members to **comply with state board licensing requirements** by allowing any AICPA firm to post voluntarily its peer review results in the AICPA's current public file regardless of membership in a specific AICPA section or audit quality center.

CASE STUDY

Q1. Develop an illustrative check list of audit programme of a reviewee for the guidance of the reviewer under the Peer Review Process?
Ans: Refer to relevant part of Point No. 12.17 (iv)

QUESTIONS

Q1. Explain the objectives of Peer Review. (4 Marks) **(Nov 2008)**
Q2. Write short note on "Reporting" stage in Peer Review. (4 Marks) **(June 2009)**
Q3. Briefly explain the Collection of evidences by Peer reviewer. (4 Marks) **(Nov 2009)**
Q4. Write short note on the "Focus of a Peer review". (3 Marks) **(May 2010)**

22. SPECIAL AUDIT TECHNIQUES

22.1 Special Audit Techniques - An audit programme specifies the techniques to be employed in the specific case by relating the techniques to the respective areas of accounting. Some of the Audit Techniques are discussed below:

i) Confirmation - it is a method of collecting audit evidence which **consists of the response to an inquiry** to corroborate information contained in the accounting records. The Guidance Note on Audit of Sundry Debtors, Loans and Advances issued by the ICAI has recommended that balances outstanding against debtors and as loan and advances should be confirmed by a procedure of communication with the parties. Direct confirmation procedure may be performed both for sundry creditors and sundry debtors.

ii) Inquiry - SA 500 mentions inquiry as one of the methods of collecting audit evidence by **seeking appropriate information from knowledgeable persons** inside or outside the entity. Inquiries may range from formal written inquiries addressed to third parties to informal oral inquiries addressed to persons inside the entity. Responses to inquiries may provide the auditor with information which he did not previously possess or may not provide him with corroborative evidence. The need for inquiry may arise at every stage of auditing.

iii) Observation - According to SA 500, Observation consists of **looking at a process or procedure being performed by others**, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed

iv) Analytical Review Procedures - Analytical review procedures may be defined as **substantive tests of financial information** made by a study of **comparisons and relationship among data.** Analytical procedures include the consideration of comparisons of the entity's financial information with, for **example**:
a. Comparable information for prior periods.
b. Anticipated results of the entity.
c. Similar industry information.

Purpose of use of Analytical Procedures - Analytical procedures are used for the following purposes:
a. to assist the auditor in planning the NTE of other audit procedures;
b. as substantive procedures when their use can be more effective or efficient than tests of details in reducing detection risk for specific FS assertions; and
c. as an overall review of the FS in the final review stage of the audit.

The extent of reliance on analytical procedures depends on several factors:
a. Materiality of the items involved, for **example**, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material;
b. Other audit procedures directed toward the same audit objectives, for **example**, other procedures performed by the auditor in reviewing the collectability of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers' accounts;
c. Accuracy with which the expected results of analytical procedures can be predicted. For **example**, the auditor will ordinarily expect greater consistency in comparing gross profit

margins from one period to another than in comparing discretionary expenses, such as research or advertising; and
d. Assessments of inherent and control risks, for **example**, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.
e. The auditor will need to consider testing the controls, if any, over the preparation information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The controls over non-financial information can often be tested in conjunction with tests of accounting–related controls. For **example**, an entity in establishing controls over the processing of sales invoices may include controls over the recording of unit sales. In these circumstances, the auditor could test the controls over recording of unit sales in conjunction with tests of controls over processing of sales invoices.

22.2 Risk Based Audit

i) Audit Risk - Audit risk is the risk that the auditor may give an **inappropriate opinion** when the FS are materially misstated. Audit risk has **three components**, viz, inherent risk, control risk and detection risk.

a. Inherent Risk - Inherent risk is the **susceptibility of an account balance or class of transaction** to a material misstatement, assuming that there were no internal controls.

Factors Affecting Inherent Risk

At level of Financial Statement	At level of Account Balance & Transaction
1. Integrity of management. 2. Management experience and knowledge. 3. Unusual pressure on management. 4. Nature of entity's business. 5. Factors affecting Industry.	1. Quality of Accounting System. 2. Accounts prone to misstatement. 3. Complex transaction. 4. Judgment involved in determining balances. 5. Assets prone to misappropriation. 6. Unusual transaction at or near period end. 7. Transaction not subjected to ordinary processing.

b. Control Risk - Control risk is the risk that material misstatements will not be **prevented or detected and corrected on a timely** basis by the **Internal Control System**.
• **Reason/Inherent Limitations of Internal Controls**
~ Cost effectiveness;
~ Transactions of unusual nature may be missed by most controls;
~ Potential of human error;
~ Circumvention of controls through collusion;
~ Abuse of control by the person who is himself responsible for exercising it;
~ Inadequacy of procedures due to changes in conditions; and
~ Manipulations by management.
• **Assessment control risk**
→ Preliminary Assessment Control Risk -
a. It refers to evaluating the likely effectiveness of an entity's internal control system in preventing or detecting and correcting material misstatements.
b. The auditor should obtain an understanding of internal controls to make a preliminary assessment of the control risk.
c. Thus, the auditor should assess the control risk as **high** unless the auditor:
• Is able to identify internal controls which are likely to prevent or detect and correct a material misstatement; and

• Plans to perform test of controls.
→ Test of controls - Auditor performs Test of Control to obtain audit evidence about:
a. Whether the accounting and internal control systems are suitably designed to prevent or detect and correct material misstatements; &
b. Operation of internal controls throughout the period.
→ Final assessment of control risk - On the basis of the results of the test of controls, the auditor should evaluate whether the preliminary assessment of control risk was correct or need to be revised. He should accordingly determine any modification in the nature, timing and extent of audit procedures.
→ Relationship between IR and CR - The auditor should make a **combined assessment** of the inherent and control risks. This is because the management generally reacts to inherent risk situations by designing suitable internal control system to prevent or detect and correct material misstatement.

c. Detection Risk - Detection risk is the risk that an auditor's **substantive procedures** will **not detect** a material misstatement.
• **Relation with other risks**
~ There is an **inverse relationship** between detection risk and the risks combined level of inherent and control risks.
~ Thus, when inherent and control risks are high, acceptable detection risk should be low to reduce the overall audit risk to an acceptably **low level.**
~ However, the assessed levels of inherent and control risk cannot be sufficiently low to eliminate the need to perform substantive procedures.
• **If detection risks Can't be reduced to acceptably low level -** The auditor should express a qualified opinion or a disclaimer of opinion.

CASE STUDIES

Q1. Indicate briefly the purposes for which analytical procedures are applied by the auditor.
Hint Ans: Refer to Point No. 22.1 (iv)

Q2. "The extent of reliance on analytical procedures depends on several factors" Explain in the light of SA 520.
Hint Ans: As per SA 520 "Analytical Procedures", the application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor's assessment of the risk that the analytical procedures depend on many factors:
Refer to Relevant Part of Point No. 22.1 (iv)

QUESTIONS

Q1. What are the considerations to be kept in mind while performing analytical procedures on data prepared by the client? (6 Marks) **(June 2009)**

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS
FINAL EXAMINATION: NOVEMBER, 2011

Question No. 1 is compulsory
Answer any five from the rest

Question 1
Comment on the following:
i) The auditor of SS Ltd. accepted the gratuity liability valuation based on the certificate issued by a qualified actuary. However, the auditor noticed that the retirement age adopted is 65 years as against the existing retirement age of 60 years. The company is considering a proposal to increase the retirement age. (5 Marks)

ii) MRE Ltd. provided Rs. 25 lakhs for Inventory obsolesce in 2009-10. In the subsequent years, it was determined that 50% of such stock was usable. The Board of Directors wants to adjust the same through prior period adjustment. (5 Marks)

iii) SRS Ltd. has drawn the financial statement as on 31-3-11 and presented to you along with additional information:
Balance Sheet of SRS Ltd. as on 31-3-11

Liabilities	Amt	Assets	Amt
Share capital Reserves & Surplus	50,00,000	**Fixed Assets**	
Profit and Loss A/c	4,00,000	Gross block Less: Depreciation	1,00,00,000
Secured Loans	75,00,000	Investments	Nil
Current Liabilities and Provisions		**Current Assets** **Loans & Advances**	
Creditors for trade	3,00,000	Debtors	25,00,000
Advance received	3,00,000	Advance Paid	10,00,000
	1,35,00,000		**1,35,00,000**

Additional Information:
a. Entire pre-operative expenses of Rs. 7, 00,000/- was charged to Profit and Loss Account whereas for the purpose of Income Tax, only what is allowable is claimed.
b. Depreciation as per Books - Rs. 35, 00,000/-
Depreciation as per Income tax -Rs. 50, 00,000/-
c. Losses to be carried forward as per Income Tax Act - Rs. 16, 00,000/-
d. Donation disallowed while computing tax - Rs. 50,000/-
Considering the additional information, can you certify that the company has complied with the Accounting Standards and issue an unqualified report? (6 Marks)

iv) ABC & Co. and DEF & Co, Chartered Accountant firms were appointed as joint auditors of Good Health Care Ltd. for 2009-10. A special audit was conducted U/s 233A of the Companies Act 1956 during March 2011 and observed gross understatement of Revenue. The revenue aspects were looked after by DEF & Co, but there was no documentation for the division of work between the joint auditors. (4 Marks)

Question 2
Comment on the following:
i) A Chartered Accountant in practice has been suspended from practice for a period of 6 months. During the said period, though he did not undertake the audit assignment since he

had surrendered certificate of practice, he had appeared before Income Tax authorities in his capacity as a Chartered Accountant. (4 Marks)

ii) Mr. J, a CA has identified that ABC Ltd. has taken a loan of Rs. 15 lakhs from Provident Fund Account, during the course of audit. The said loan was not reflected in the books of accounts and statements were prepared ignoring the same. (4 Marks)

iii) Mr. K, a Chartered Accountant certified the circulation of a weekly magazine without examining the records and relevant documents. (4 Marks)

iv) Mr. R, a Chartered Accountant in practice approached Manager of a Nationalised Bank for a loan of Rs. 25 lakhs. He has also informed the Manager that if the loan is sanctioned, the Income Tax return of the Manager and staff will be filed without charging any fees, as quid Pro quo for the loan sanctioned. (4 Marks)

Question 3

i) XYZ Pvt. Ltd. has submitted the financial statements for the year ended 31.3.11 for audit. The audit assistant observes and brings to your notice that the company's records show following dues:
Income Tax relating to Assessment Year 2007-08 Rs. 125 lacs - Appeal is pending before Hon'ble ITAT since 30-9-09.
Customs duty Rs. 85 lakhs - Demand notice received on 15-9-10 but no action has been taken to pay or appeal.
As an auditor, how would you bring this fact to the members? (5 Marks)

ii) State the functions of Energy Auditor. (5 Marks)

iii) An infrastructure company has constructed a mall and entered into agreement with tenants towards license fees (monthly rental) and variable license fees, a percentage on the turnover of the tenant (on an annual basis). Chief Finance Officer wants to count/recognize license fee as income for 12 months during current year under audit and variable license fees as income during next year, since invoice is raised in the subsequent year. As an auditor, how would you deal and state in the statement of Accounting policies? (6 Marks)

Question 4

i) XY Ltd. is a manufacturing company, provided following details of wastages of raw materials in percentage, for various months. You have been asked to enquire into causes of abnormal wastage of raw materials. Draw out an audit plan.
Wastage percentages are
July 2010 - 1.5%
Aug 2010 - 1.7%
Sep 2010 - 1.4%
Oct 2010 - 4.1% (8 Marks)

ii) Briefly explain the steps involved in Audit under Indirect Tax. (8 Marks)

Question 5

i) As a tax auditor how would you deal and report the following:
a. An assesses has borrowed Rs. 50 lakhs from various persons. Some of them by way of cash and some of them by way of Account payee cheque /Draft
b. An assesses has paid Rent to his brother Rs. 2, 50,000/- and paid interest to his sister Rs. 4, 00,000/-

c. An assesses has incurred payment to clubs. (3 + 2 + 2 = 7 Marks)

ii) As a bank branch auditor, what aspects will be considered while reporting on credit appraisal, sanctioning /disbursement and documentation in respect of advances in the LFAR? (5 Marks)

iii) ABC Private Ltd. has granted loan of Rs. 20 crores to XYZ Ltd. a sister concern and it remains outstanding at the year end. How would you report the fact? (4 Marks)

Question 6

i) Corporate responsibility as envisaged under SOX Act-2002. Briefly explain. (3 Marks)

ii) State briefly the basic elements of Management Representation Letter. (2 Marks)

iii) You are a member of an audit team of B & C Associates, auditors of a Multinational Company YB Co. Ltd. The company is working in CIS environment. The partner in charge of B & C Associates asked you to draw out the audit plan for evaluating the reliability of controls. (5 Marks)

iv) Y Co. Ltd. has five entertainment centers to provide recreational facilities for public especially for children and youngsters at 5 different locations in the peripheral of 200 kilometers. Collections are made in cash. Specify the adequate system towards collection of money. (6 Marks)

Question 7

Write short notes on any four of the following:

i) Contract notes in case of audit of member of Stock Exchange. (4 Marks)

ii) Scope of Peer Review. (4 Marks)

iii) Audit procedure in respect of "Outstanding premium and Agents balance" in Insurance Company. (4 Marks)

iv) C&AG of India were conducting supplementary audit U/s 619 (3) (b) of the Companies Act, 1956 made certain comments on the reported foreign exchange loss in the accounts of a Public sector company. The BOD failed to reply to the comments of C&AG in their report-Comment. (4 Marks)

v) Propriety elements in CARO 2003. (4 Marks)

PAPER – 3: ADVANCED AUDITING AND PROFESSIONAL ETHICS
FINAL EXAMINATION: MAY 2012

Question No. 1 is compulsory
Answer any five from the rest

Question 1

i) A Ltd is a manufacturer of readymade garments. It sells its products to franchisees located across the country. Readymade garment industry is subject to change in trends of fashion and as such, some of the goods are returned and A Ltd accepts them back as sales returns. On the basis of past trends such returns are estimated to be at 20% of the sales of any year. For the FY 2011-12, A Ltd had accounted for the actual sales return made up to 31.03.2012 but has not reversed the possible expected return that are likely to happen after 31.03.2012, in respect of the sale made for the FY 11-12. Mr. X the auditor of A Ltd wants this to be considered in the accounts for the year ended on 31.03.2012 but the company is of the opinion that although there is a probability of some goods being returned by the franchisees, there is no significant uncertainty regarding the amount of consideration that will be derived from the sale of goods, since the goods are not in the possession of the company and risk and rewards of ownership still lie with the franchisees and the company cannot record sales returns in its books of account in respect of goods that are likely to be received after the date of balance sheet. Comment. (5 Marks)

ii) R & Co. is the statutory auditor of S Ltd. for the FY ended on 31st March 2012, S Ltd had disclosed in the notes "The state pollution control board had ordered the closure of the company's only manufacturing plant on the ground that it is environmentally damaging, which the company had challenged in a law suit. Pending the outcome of the law suit the FS are prepared on a going concern basis". Further the financial statements prepared by the management of S Ltd include financial statements of certain branches which are audited by other auditors. What are the reporting responsibilities of R & Co? (10 Marks)

iii) In the course of the statutory audit of Z Ltd, its statutory auditors, having determined that the work of internal auditor is likely to be adequate for the purpose of statutory audit, wanted to use the work of internal auditor in respect of physical verification of fixed assets. How an evaluation of this specific work done by the internal auditor can be done? (5 Marks)

Question 2

Give your comments with reference to CA Act, 1949 and Schedules thereto:

i) Z, a practicing CA issued a certificate of circulation of a periodical without going into the most elementary details of how the circulation of a periodical was being maintained i.e. by not looking into the financial records, bank statements/pass books, by not examining evidence of actual payment of printers bills and by not caring to ascertain how many copies were sold and paid for. (4 Marks)

ii) X, a practicing CA in an application for permission to study submitted by his Articled Assistant to the council had confirmed that the normal working hours of his office were from 11 A.M. to 6 P.M. and the hours during which the Articled Assistant was required to attend classes were 7.00 A.M. to 9.30 A.M. According to the information from College, Articled Assistant attended College from 10 A.M. to 1.55 P.M. on all week days. About the Articled Assistant attending the classes even during office hours, X pleaded ignorance. (4 Marks)

iii) K, a practicing CA gave 50% of the audit fees received by him to L, who was not a CA, under the nomenclature of office allowance and such an arrangement continued for a number of years. (4 Marks)

iv) M, a practicing CA sent a letter to another firm of CAs, claiming himself to be a pioneer in liasoning with Central Government Ministries and its allied Departments for getting various Government clearances for which he had claimed to have expertise and had given a list of his existing clients and details of his staff etc. (4 Marks)

Question 3/
i) As the concurrent auditor of Z Bank Ltd you are requested by its management to draft an internal control policy in respect of loans and advances. What factors do you consider as important while drafting such a policy? (10 Marks)

ii) T Ltd's previous year ended on 31st March 2012. During that period it made a claim for refund of customs duty which was admitted as due by the customs authorities during April 2012. T Ltd neither credited the claim in the profit and loss account nor reported the same in clause 13(b) of Form 3CD for the reason that this has been admitted as due by the authorities only in the next financial year. Further T Ltd had changed the method of determination of cost formula for the purpose of stock valuation from FIFO basis to Weighted Average Cost basis, but that was also not reflected in clause 1(b) of Form 3CD which requires reporting on change in accounting method employed. Comment (6 Marks)

Question 4
i) During audit of Q Ltd, statutory auditor wants to be sure of adequacy of related party disclosures? Guide him in identifying the source of related party information. (8 Marks)

ii) Z Ltd is intending to acquire A Ltd. It hires B & Co., a firm of Chartered Accountants to conduct a due diligence. B & Co., wants to reduce the risk of over valuation of assets in its due diligence exercise. Kindly guide B & Co. (8 Marks)

Question 5
i) A, a practicing CA is appointed to conduct peer review of another practicing unit. What areas A should review in the assessment of independence of the practicing unit? (4 Marks)

ii) State the key differences between financial and operational audit. (4 Marks)

iii) "Non-compliance of Section 58 AA inserted by the Companies (Amendment) Act, 2000 would occur where the company fails to intimate the CLB, any default in repayment of deposits made by small depositors or part thereof or any interest there on." Discuss this statement and state reporting requirements under the CARO, 2003 for non-compliance of Section 58 AA of the Companies Act, 1956. (8 Marks)

Question 6
i) In the audit of K Ltd, its auditor wants to use CAATs for performing various audit procedures. Guide him as to what procedures can be performed using CAATs. (6 Marks)
ii) State the "Mandatory Review" areas of the audit committee. (4 Marks)
iii) In the course of audit of A Ltd you suspect the management is indulged in fraudulent financial reporting? State the source of such fraudulent financial reporting. (6 Marks)

Question 7 - Write short notes on any four of the following:
i) Mark to Market Margin. (4 Marks)
ii) Cost Statements. (4 Marks)
iii) Matter to be reported in respect of inventory in the case of a special audit of a non-corporate borrower of a Bank. (4 Marks)
iv) Solvency Margin. (4 Marks)
v) Statistical and Non-Statistical Sampling. (4 Marks)