# PROFESSIONAL MISCONDUCT

**By: Mrs. Surbhi Bansal**
*M.Com., FCA*

**Sec.2 (2):**

Members deemed to be in practice: If he

**(i)** **Engages** himself in practice of accountancy, or

**(ii)** **Offers** to perform audit related services or **holds** himself out to the public as an accountant, or

**(iii)** **Renders professional** service or assistance in Matters of accountant interest etc., or,

**(iv)** **Renders** such other services which as per opinion of the council, to be rendered by C.A. in practice. (Mgt. consultancy service)

**Explanation :** (1) C.A. who is salaried employer of C.A. in practice shall be deemed to be in practice for limited purposes of training articled clerk.

(2) C.A. shall be deemed to be in practice if he, in his professional capacity (not in personal/employee's capacity) acts as liquidator, trustee, executor, adviser & same or takes up an appointment mate by Govt. or court or other legal authority. However for this purpose his engagement shouldn't be on a salary-cum- full time basis.

**Significance of certificate of Practice**:

As per judicial ruling;

(i) Once a member of ICAI appears before I.T. authorities etc. he can so appear only in his capacity as a C.A.

(ii) Thus for period of suspension, he can't practice as I.T. practitioner even if he is having law degree.

(iii) Thus, a member of ICAI can't have other capacity, separable from his capacity to practice as a member of the Institute.

**Section 7:**

A member in practice can't use any other designation than that of a Chartered Accountant nor any other description whether in addition thereto or in substitution therefore. However they can use any other letter etc. indicating degree of other institutions.

**Section 8 :** Disabilities for purpose of membership :

(i) If he isn't 21 yrs. or
(ii) If he is of unsound mind as per a competent Court, or
(iii) Undischarged insolvent, or
(iv) Discharged insolvent but hasn't obtained from the court a certificate starting that his insolvency was by misfortune without any misconduct on his part, or
(v) Convicted of an offence involving moral turpitude unless he has been granted a pardon etc. or
(vi) If removed from membership of ICAI due to misconduct.

If the person fails to disclose the fact that he suffers from any of disabilities aforementioned, it will constitute professional misconduct on his part.

**Section 21 :** Procedure in enquires for disciplinary matters :

Complaint → Council → Disciplinary Committee → Council → High Court (if need arises)

Complaint → Council whether it is fit for case or not → fit → D.C. (I$^{st}$ Schedule) (Having evidences explanation & than recommended report supply to council) → Council

→ unfit reject

(Prima facie opinion Whether complaint is fit. It is not deciding)

Council → Pass the decision

Council → Refer to H.C (If in I$^{st}$ Schedule to be removed from register for more than 5 yrs. if it falls in II$^{nd}$ schedule)

**(i)** At first stage, council is framing just prima facie opinion with respect to complaint.
**(ii)** It is not deciding whether C.A is guilty or not.
**(iii)** Normally no fresh evidences are permitted before council, once the disciplinary committee submitted its report to council. However council may permitted the same at its own discretion.
**(iv)** The recommendation report of D.C. in to be given to C. A concerned before submitting it to the council & it is also giving opportunity of being heard.
**(v)** The C.A. concerned will appear to council either himself or may be represented by some other C.A (not by Lower)
**(vi)** Without any complaint, the council may also take any action suo-moto.

**<u>Section 24:</u>** Penalty for falsely claiming to be a member :
Any person who :
(i) Not being member of ICAI represents that he is a member of Institute or uses the designation Chartered Accountant, or
(ii) Being member of ICAI but not having COP represents that he is in practice or practices as CA, Shall be punished.

**<u>Section 27 :</u> Maintenance of Branch office :**
*Office:* Where name Board of firm is affixed or which is described as place of business on any professional stationary. Thus a C.A can have a name plate of himself describing him as Chartered Accountant but not that of the firm at his place of residence, as it will be construed as branch

As a general rule, Each one of such offices should be in separate charge of a member of Institute.

**Exception (No separate in charge is needed)**

| For member practicing is Hilly Areas | For all members |
|---|---|
| (i) In plains for period $\leq 3$ months in winter season, &<br>(ii) Temporary office not to be mentioned as place of Business &<br>(iii) Correspondence continue at permanent office, &.<br>(iv) Before coming to plains in every winter & at close of such office in plains, inform ICAI.<br>(v) Name board of firm to be displayed at temporary office only during these 3 months. | (i) If second office is located in same accommodation or premises or<br>(ii) If second office is located in same city, or<br>(iii) If second office is Located within 50 kms. From Municipal limits of city in which I$^{st}$ office in situated. |

**Schedules**

**First Schedule**
(order passed by council. Refer to H.C. only if C.A. is to be removed from register of members for more than 5 yrs.)

- **Part 1** (13 clauses ) CA in practice
- **Part 2** (3 clauses ) CA in service
- **Part 3** (3 clauses) CA general

**Second Schedule**
(Straight forward refer to H.C.)

- **Part 1** (10 clauses) CA in practice
- **Part 2** (2 clauses) CA general

## *First Schedule*

### *Part I (C.A. in Practice)*

***Clause 1 :***

Allows any person to practice in his name as a C.A. unless such person is also a C.A. in practice and is in partnership with or employed by himself.

***Clause 2 :***

Pays / allows / agrees to pay or allow directly or indirectly any share commission or brokerage in fees or profits of his professional business to any person other than a member or partner or retired partner or legal representative of deceased partner.

⇒ Widow can continue to receive a share of firm if partnership agreement contains a provision.

⇒ Now onwards, on death of sole proprietor, the name of the firm will be kept in abeyance by the institute for one year so that to enable the widow of deceased to sell g/w of the firm.

For deaths

on of offer 30th Aug, 98 | on or before 29th Aug, 98

| *Normal Cases* | *Disputed Cases* | |
|---|---|---|
| Name will be kept in abeyance upto one years from death | Till one year from the date of settlement of dispute provided information as to dispute is received by ICAI within 1 year of death. | If firm name is still available with ICAI. Upto 28th Aug, 99 (irrespective of time lag between date of death & 29th Aug, 98). |

***Clause 3 :***

Accepts / Agrees to accept any part of the profits of the professional work of a lawyer, auctioneers, broker or other agent who is not a member of institute.

***Clause 4 :***

Enters into partnership with any person other than C.A. in practice or a person resident without India who but for his residence would be entitled to be registered or whose qualification are recognized by Govt./ Council / provided C.A. shares in fee / profits of business of partnership both within and without India.

⇒ This clause applies only to profession of C.A. and not to other business, which is covered by clause 11.

⇒ ***Clause 5 :***

Secures, either through the services of a person not qualified to be his partner or by means which are not open to a C.A., any professional business.

***Clause 6 :***

Solicits clients or professional work either directly or indirectly, by circular, advertisement, personal communication or by any other means."

(a) ***Adv. And note in press :*** As a general rule he **can't advertise**

***Exception :***

(i) change in partnership, address and tel. no. having bare statement of fact and no. of insertion and limited distribution of new spares.

(ii) Classified ad. In journal / news letter of institute for sharing professional work/partnership, etc. provided firm name and address is not given.

(b) ***Empanelment for allotment of audit/proff. work :***

⇒ Only if penal's existence is known.

⇒ No roving enquiries

⇒ Quote fee only if enquired.

⇒ No printed / cyclostated copies of fee.

⇒ Shouldn't respond to empanelment requiring registration or other fee or other deposit. *However as per new notification, a C.A. can respond to tender etc. if required by Govt. agency etc. In this case, he can pay reasonable price for tender document. For earnest money, if services are restricted to C.A. as per law, they can't deposit otherwise they can.*

(c) ***Publication in telephone / other directories :***

⇒ Section of C.A. belonging to particular town / city.

⇒ Normal letters, logical order.

⇒ Reasonable payment, no restriction on entries.

⇒ No impression of publicity.

(d) ***Responding to Tendors, Adv. / Circulars :***

⇒ Shouldn't Respond to

⇒ (i) adv. For appointment.

(ii) Quotation for services restricted to C.A. and

(iii) Inquiry for quotation of fee if it is made to more than one C.A.

⇒ However, they can respond(i) in other areas(other than audit) where they compete with non C.A. and (ii)in outside country(even in audit field) if receipts are in foreign currency(ensure not to constitute undercutting and also confirm to minimum fee restrictions prescribed by ICAI)

⇒ However as per new notification, when matter relates to audit and related services, which as per law can be provided only by a C.A. the member may respond to such adv./queries/letter etc. if same is sought by World bank/IMF/Asian development Bank or similar Institution or any Govt. Co. or entity sponsored by Govt./nationalized Institution or any similar body.

(e) ***Issuing Hand Bills :***

To persons other than clients such as changes in tax.

(f) ***Publication of Books and Articles :***
No indication as to association with any firm of C.A.

(g) ***Issue of greeting cards or invitation :***
Designation and name of the firm may be printed on invitation provided sent to clients relatives and close friends.

(h) ***Roving inquiries :***
No sending of such inquiries to prospective clients.

(i) ***Seeking work from professional colleagues :***
Not permissible except in a(ii)i.e. journal.

(j) ***Scope of Representation U/S 225(3) :***
Merely state that he has acted independently and may indicate willingness but no extra publicity. No derogatory remarks against company.

(k) ***Acceptance of work, emanating from a client introduced by other C.A. :***
Shouldn't accept. Client should come through the introducing C.A.

(l) ***Public Interview :***
No publicity, details about firm / professional attainments.

(m) ***Adv. Ur Bondex No. :***
Prohibition.

(n) ***Web-site :***
⇒ CA / CA firm free to create own website (no std. Format, no restriction on colour).
⇒ Website run on 'pull' mode not on 'push'.
⇒ Can mention Website Address on professional. stationery.
⇒ Specific.' pull' request for :
(i) Nature of services rendered.
(ii) Area of Exp. of partners.
(iii) Area of exp. of employees.
(iv) No. of articled clerks.
(v) Nature of assignment handled.
⇒ *Can't give* : (i) Name of clients and fee charged; (ii) No logo; (iii) No photograph(however passport size photograph of member can be given) (iv) No Adv. (v) Ref. About website (other than that of ICAI and Govt. related.).
⇒ Articles etc. of professional interest can be given.
⇒ Bulletin Boards can be provided.
⇒ Chat room between client and CA is permitted.
⇒ Listing on suitable search engine is permitted if restricted to CA, Indian CPA etc.
⇒ Details shouldn't solicit client or adv.
⇒ Secrecy of matters of clients through website.
⇒ If he is member of a professional body or chamber of commerce offering listing → permitted.
⇒ Strict compliance with guidelines is required.
⇒ Address of website can be diff. from name of the firm but should be as near as possible to such name of CA/CA firm).
⇒ Address of website → intimation to ICAI alongwith annual membership form.
⇒ Mention date upto which it is updated.
⇒ They can provide services through other websites also provided contact address of CA and professional achievement is not given.

***Clause 7 :***

Advertises his professional attainment or services or uses any designation or expression other than Chartered Accountant on professional. documents, visiting cards, letter heads or sign boards unless it be a degree of an University established by law in India or recognized by the Central Government or a title indicating membership of ICAI or any other institute recognized by Central Govt./by Council.

⇒ He can't use words like income-tax consultant, cost consultant or management consultant.

⇒ Can't use 'Member of Parliament', etc. in addition to that of Chartered Accountant.

⇒ Persons eligible otherwise, subject to permission may practice as advocates but can't use designation "Chartered Accountant" and "Advocate" simultaneously.

⇒ Name, description and address of member (firm) may appear in any directory or list of members of a particular body (alphabetically). He may provide appropriate directorship held and reasonable personal details (outside Interest) but not name of clients and services offered by his firm.

⇒ Photograph and brief particulars in magazine (No payment/No Adv.).

⇒ Advertisement is permissible (not bolder than substance)
- (i) Recruiting staff in own office.
- (ii) Recruiting staff or acquiring/disposing business/property on behalf of client.
- (iii) Sale of Business/Property acting as trustee, liquidator or receiver.

⇒ Success in exams may be given without any undesirable publicity w.r.t member/firm/clerk.

⇒ May appear on T.V. films/Radio, etc. describe themselves as Chartered Accountant qualification but no reference, as to name/address/services of firm. It is a duty of C. A to insure that host doesn't refer to any such think.

⇒ Publicity is permitted for appointment of position of local/national importance, etc. They may mention membership of ICAI but not firm.

⇒ Use of glow sign-board/light or large size board is not proper. He may have a name board of himself at residence but not of a firm.

⇒ Prospectus of the company in which he is a director shouldn't advertise his professional attainment. Firm name not permissible. Expression like "In association with ……..", "Associates of ……………" not proper.

⇒ Use of logo ⇒ not permissible at all.

***Clause 8 :***

Accept a position as Auditor previously held by another chartered accountant or restricted state auditor without first communicating with him in writing.

⇒ Professional reasons for not accepting Audit fee.
- (i) Non-compliance of provisions of section 224 and 225.
- (ii) Undercutting of fee.
- (iii) Non-payment of undisputed audit fee (except sick unit)
- (iv) Issuance of qualified Report.

⇒ In first three, if he accepts professional misconduct. In (iv), he may accept if he thinks that attitude of retiring auditor wasn't proper and justified. But if he qualified it for good and valid reasons, he should refuse.

⇒ If dispute regarding fee not paid, he (incoming) may use his influence in favour of his predecessor to have dispute settled.

⇒ If prospective clients tells the member about change of auditor. Ask him if retiring one has been informed, if yes communicate with retiring. If not, ask reasons for change if no valid reasons he shouldn't accept. However, if he chooses to accept, communicate with retiring.

⇒ Incoming can act after waiting for reasonable time for a reply.

⇒ Mere posting "under certificate of posting" is not sufficient. Positive evidence (acknowledgement) that letter has in fact reached the person.

⇒ Applies to all audit assignment including internal concurrent, tax audit, healthy practice for special audit u/s 142(2A) of I.T. Act also.

⇒ Outgoing should sent a reply as soon as possible (No violation of confidentiality).

⇒ Duty of communication is absolute & required is every case, even when appointment is made by government or when if previous auditor knows about the appointment.

⇒ The incoming auditor should communicate with previous auditor who was there in same capacity.

⇒ Take care of new point in AAS-4.

***Clause 9 :***

Accepts an appointment as auditor of a company without ascertaining from it whether requirement of section 225, in respect of such appointment have been duly complied with.

***Clause 10 :***

Charges/offers to change accepts/offers to accept w.r.t. any professional employment, fee based on a % of profits or which are contingent upon findings or results of such employment, except in cases which are permitted.

⇒ Not contingent if fixed by court/public authority.

⇒ Exception (may by % of profits) :

(i) Receiver or liquidator (% of realization).

(ii) Auditor of Co-op. Society (% of paid up/working capital, gross/net income/profit.

(iii) Valuer.

***Clause 11 :***

Engage in any Business (occupation other than profession of C.A. unless permitted by council so to engage.

However, he can always become director (not M.D.) in a company provided he/his partner is not interested in such co., as an auditor.

***"General Permission"***

(i) Employment under C.A./C.A. firm.

(ii) Private tutorship.

(iii) Authorship of Books/Articles.

(iv) Holding Life Insurance Agency licence (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.

***"Specific Permission"***

(1) Full time/Part time employment in Business concerns provided he/his relative not having sub. intt.

(2) Full time/Part time employment in non-business concern.

(3) Managing Director/Whole-time Director concern.

(4) Intt. In family Business concern.

(5) Intt. In agriculture/allied activities with help of hired labour.

(6) Intt. In any educational institute.

(7) Part time/Full time lectureship for courses other than C.A. exams.

(8) Part time/Full time tutorship under any educational institute other than coaching org. of institute.

(9) Editorship of journal other than professional one.

(10)Any other Business/Occupation considering it to be necessary to take permission.

However, they may act as liquidator trustee, executor, etc., or may take an appointment made by Govt./Court/Legal Authority in professional. capacity provided it is not a salary-cum-full-time basis.

⇒ If not designated as M.D. or W.T.D. but entrusted with whole/substantially the whole of management of affairs of company, deemed to be M.D.

The Council at its 242nd meeting noted the recommendations made to it by the Executive Committee and accordingly passed the following resolution as a part of and in continuation of the existing resolution under Regulation 190A which appears as Appendix no. 9 to the C.A. Regulations, 1988 (2002 edition)

IT IS FURTHER REOLVED that the general and specific permission granted by the Council is subject to the condition that –

(i) Any member engaged in any other business or occupation, in terms of general or specific permission granted as per Appendix NO. (9) shall not be entitled to perform any attest function except in the following cases:
   - (a) Authorship of books and articles.
   - (b) Holding of Life Assurance Agency Licence for the limited purpose of getting renewal commission.
   - (c) Attending classes and appearing for any examination.
   - (d) Holding of public elective offices such as M.P., MLA & MLC.
   - (e) Honorary office-bearership of charitable, educational or other non-commercial organizations.
   - (f) Acting as Notary Public, Justice of the Peace, Special Executive Magistrate and the like.
   - (g) Part-time tutorship under the Coaching Organisation of the Institute.
   - (h) Valuation of papers, acting as paper-setter, head-examiner or a moderator for an examination.
   - (i) Editorship of professional journals – (not in employment)
   - (j) Acting as surveyor and Loss Assessor under the Insurance Act, 1938 (not in employment).
   - (k) Acting as Recovery consultant in the Banking Sector (not in employment)
   - (l) Any coaching assignment organized by the Institute, its Regional Councils and Branches of Regional Councils.
   - (m) Engagement as Lecturer in an University, affiliated college, educational institution, coaching organisation, private tutorship, provided the direct teaching hours developed to such activities taken together do not exceed 25 hours a week.
   - (n) Engagement in any other business or occupation permitted by the Executive Committee from time to time.
   - (o) Insurance brokerage.

(ii) A member who is not entitled to perform attest function shall not be entitled to train articled clerks.

***Clause 12 :***

Accepts a position as auditor previously held by another in such condition as to constitute undercutting.

***Consider the following:***

(i) Quantum of work.

(ii) Incidental and out Of pocket expenses.

(iii) Other terms of appointment.

***Clause 13 :***

Allows a person not C.A. or a member not his partner to sign on his or his firm behalf, any B/S, P&L A/c. report of financial statement,

***PART – II***

***In relation to C.A. in service***

(a) If pays/allows/agrees to pay directly/indirectly to any person any share in emoluments of the employment undertaken by member.

(b) Accepts/agrees to accept any part of fees, payment or gain from a lawyer, C.A., broker engaged by company, firm or person or agent or customer of such company, firm or person by way of commission or gratification.

(c) Discloses confidential information acquired in the course of his employment except as and when required by law/permitted by employer.

***PART – III***

***In relation to C.A. (generally)***

(i) If he includes in any statement, return or form to be submitted to council, particulars knowing them to be false.
(ii) If he, not being a fellow styles himself as a fellow.
(iii) Doesn't supply information called for, or doesn't comply with requirement asked for, by council or any of its committees.

***SECOND SCHEDULE***

*Referred to H.C. for decisions*

***PART – I***

***Professional misconduct in relation to C.A. in practice.***

***Clause 1 :***

Discloses information acquired in the course of his professional engagement to any person other than his client, without consent of his client or otherwise than as required by any law for the time being in force.

⇒ Request for disclosure must come from client.

⇒ *Duty in relation to unlawful act by client :*

(i) No duty on C.A. to inform I.T. Authorities.
(ii) No duty to shield him from consequences of tax frauds.
(iii) Disclosure immediately. If small fraud may be made with submission of current return.
(iv) Genuine mistake/omission client won't object to make complete disclosure.
(v) Fraud in past returns/A/c. in which no same C.A. Client Is advised to disclose. He may continue to act.
(vi) Fraud relates to A/c. examined/reported by same C.A. client advised to disclose. If he refuses, disassociate himself and disclose the same in report to authorities.
(vii) If fraud in returns/a/c. currently being prepared client advised to disclose. Else reservation in his report and disassociate with return.
(viii) Member's assignment is dispensed with before A/c. completed/reported on/return submitted → no further duty.
(ix) Relates to A/c. not prepared/reported by member, for example where he is preparing business returns while fraud is there is individual return of partner, he may continue with Business A/c. but under no obligation to do so.
(x) Impression on Client :
    (a) Disclosure only penalty, non disclosure with fine/imprisonment.

(b) Intimation by member to I.T. authorities about disassociation can start investigation against client.

(xi) Summon the member to examine him on oath, legal expert advice is taken.

(xii) For production of Books of Accounts/Documents → Expert advice.

***Clause 2 :***

If he certifies/submits in his/his firm's name a report of an examination of financial statements unless examination is made by him / a partner / employee / another C.A. in practice.

***Clause 3 :***

Permits his / his firm's name to be used in connection with estimate of earnings contingent upon future transaction in manner which may lead to belief that he vouches for accuracy of the forecast.

⇒ He may participate in preparing and servicing them provided he clearly indicates source of information, basis of forecasts and major assumption and so long as he doesn't vouch for accuracy of the forecasts.

***Clause 4 :***

Expresses his opinion on Financial Statement of any Business / Enterprise in which he, his firm or partner has substantial intt. Unless he discloses intt. Also in his report.

⇒ Council clarification : He or his firm name shouldn't accept.
(i) Accept auditorship of college in which he's lecturer.
(ii) Accept auditorship of trust wherein he/partner is either employee or a trustee.

⇒ Enterprise/Business in which he's either owner or partner → shouldn't accept.

⇒ Enterprise/Business in which his partner/relative has sub. intt. → Disclose the fact if audit the same.

⇒ Company in which he is director → shouldn't accept.

⇒ Company in which his Partner/Relative is director having sub. Intt. → Disclose the fact if audit the same.

⇒ He should take care of the same while acting as Tax Consultant/Financial Advisor also.

⇒ Members not to write Books of Account of clients.

⇒ St. Auditor not to become its Internal Auditor.

***Clause 5 :***

Fails to disclose a material fact known to him which is not disclosed in the Financial Statement, but disclosure of which is necessary to make financial statements not misleading
→ Refer to SAP-13 'Materiality' and AS.

***Clause 6 :***

Fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity.

***Clause 7 :***

Is grossly negligent in conduct of his professional duties.

⇒ He should perform it with due skill and care.

⇒ Like in circulation of newspapers (certification).

***Clause 8 :***

Fails to obtain sufficient information to warrant the expression of opinion as his exception are sufficient material to negate the expression of opinion.

⇒ He shouldn't express it before obtaining required information.

⇒ He should reproduce (brief self-explanatory explanation) the notes of qualificatory nature in report to enable reader to know importance of these qualification.

***Clause 9 :***

Fails to invite attention to any material departure from generally accepted procedure of audit applicable to the circumstances.

⇒ Refer to AAS .

***Clause 10 :***

Fails to keep moneys of his client in separate banking A/c. or to use such moneys for purposes other than those for which they are intended.

*Explanations :*

(i) Advance received by C.A. against services to be rendered doesn't fall under this clause.

(ii) It doesn't apply to expenses to be spent within reasonably short time. These need not be deposited into separate bank account.

## ***PART - II***
## ***Members of the Institute Generally.***

***Clause 1 :***

Contravenes any of the provisions of this Act or Regulation made thereunder.

⇒ Mainly in connection with Articles, part-time employment, restriction on fees.

⇒ **Some important points:**

1. Monthly payment of stipend to every article. It must be confirmed beyond all doubts that payment has been made.
2. It is duty of C.A to forward article deed to ICAI.
3. A CA can't take loan from any enterprise in which article is interested. However he may accept the same from any enterprise where in articles farther or relative is interested. But it must not be taken as a consideration for admitting the article into firm.
4. Now no premium can be accepted by C.A
5. Practice work only after obtaining COP.

***Clause 2 :***

Is guilty of such other act or omission as may be specified by the Council in this behalf, by notification in the Gazette of India.

**NOTIFICATIONS**

⇒ He shouldn't be cost auditor of company in which he
(i) Is auditor (ii) Is officer/employee; (iii) Partner, or in employment of officer/employee of co.; (iv) Partner or in employment of company's auditor; (v) Indebted for > 1000 Rs., guarantor.

⇒ Member in practice can't become auditor of company., while he's an employee of cost auditor of co.

⇒ A member who is an employee shall be deemed to be guilty if he is willfully & grossly negligent in conduct of his duty as employee.

⇒ C.A in practice is to maintain proper Books of Accounts including Cash Book / Ledger.

⇒ If he accepts more than sp. tax audit assignments (30).

⇒ If becomes member of CFA in addition to C.A.

⇒ Accepts less fee than specified.

| | *4 – 7 partner* | *≥ 8 partner* |
|---|---|---|
| Large cities | 5000 | 9000 |
| Small cities | 3000 | 6000 |

*Exception :*

(i) Honarary for Charitable, Club.

(ii) RRB Branches.

(iii) Newly concern (2 yr.)

(iv) Certificate/Attestation/Report under IT Act.

- ⇒ A Chartered will be guilty of professional misconduct, if he accepts statutory auditorship of PSU/ listed Co./Govt Co./Other Public Co. having turnover exceeding 50 crores 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.
- ⇒ As auditor of a concern while he is indebted to the concern or has given any guarantee for limits fixed in the statute & in other cases exceeding Rs. 10,000.

# AUDITING AND ASSURANCE STANDARD

## AAS – 1

## BASIC PRINCIPLES GOVERNING AN AUDIT

**Documentation :** The auditor should maintain documentation of the important matters.

**Integrity, Objectivity and Independence :**

- Auditor should be interest free. He must possess qualities such as honesty, sincereness, fairness, objectivity, etc.

**Skills and Competence :** Auditor must have adequate training, competence and experience.

**Confidentiality :** Auditor must not disclose any confidential information regarding his client to any third party. However, he may disclose, if –

(i) There is a specific permission of client or

(ii) Required by law.

**Work performed by others :** Auditor may rely on work done by others i.e. other auditors or experts or his assistants provided he exercised due skill and care and there is nothing to doubt.

**Planning :** For proper conduct of work in efficient and timely manner.

**Audit Evidence :** Sufficient and appropriate evidence should be obtained by performing compliance and substantive procedures.

**Accounting Systems and Internal Controls :** Management is responsible for maintaining the same. The auditor has to check their adequacy.

**Conclusion and Reporting :** Auditor is required to express opinion on financial information on the basis of conclusions drawn from evidences. He is required to conclude whether -

(a) Financial information is prepared using consistent and acceptable accounting policies.

(b) Financial statements comply with relevant regulations.

(c) There is adequate disclosure of all material matters.

There should be clear expression of opinion in report. If the report is other than unqualified, auditor should state the reason for the same.

## AAS- 2

## OBJECTIVE AND SCOPE OF THE AUDIT OF FINANCIAL STATEMENTS

The term 'General. Purpose Financial Statements' include Balance Sheet, Profit and Loss Account and other statements and explanatory notes which from part thereof.

1. **Objective of an Audit** - The audit of financial statements is undertaken with the objective to 'enable the auditor to express an opinion on such financial statements. For this, it is essential that financial statements are prepared as per the recognized accounting policies and practices and relevant statutory requirements.

   The auditor's opinion does not constitute an assurance as to future viability of the enterprise, or the efficiency or effectiveness with which its management has conducted the affairs of the enterprise.

2. **Responsibility for the financial statements** - The management is responsible for maintaining an up to date and proper accounting of various transactions entered into during the course of the year. The auditor is responsible for forming and expressing an opinion on the financial statements. The audit of the financial statements, does not relieve the management of its responsibility.

3. **Scope of an Audit** - The auditor decides the scope of his audit having regard to
   a. The terms of the engagement
   b. The requirements of the relevant legislation
   c. The pronouncements of the Institute (ICAI)
   d. The judgments of various courts of law

   However, the terms of engagement can not supercede the pronouncements of the Institute or the provisions of relevant legislation.

4. **Organising an Audit** - The audit should adequately cover all aspects of the enterprise which are relevant to the financial statements under audit. The auditor should be reasonably satisfied that the information contained in the accounting records, etc. is reliable and sufficient.The auditor should compare the financial statements with accounting records and other source data to satisfy himself that there is no variation between the two. He should assess the basis of selection of accounting policies and their consistent application. He should satisfy himself about the compliance with the various relevant laws and rulings of various courts of law.

5. **Inherent limitations of Audit** - The auditor, with a view to forming his opinion on the financial statements follows certain audit procedures. He recognizes that because of the limitations inherent in the test checks, audit and any system of internal control, some material misstatement may remain undiscovered. It is true that in many situation a material misstatement by management may be discovered in the course of an audit, but such discovery is not the main objective of the audit. However, the auditor should extend his procedures, if he has any indication that some fraud or error, which is likely to result in material misstatement, may have taken place.

   The auditor is primarily concerned with, the items, which, whether individually or as a group, are material in relation to the affairs of an enterprise. However, in the absence of any definite standard to judge materiality, the auditor should make a decision about it on the basis. of his professional experience and judgment.

   The auditor is not expected to perform duties, which are outside the scope of his competence, e.g. determining physical condition of certain assets.

   If there are any constraints as regards the scope of audit, he should set them out in his report and render a qualified opinion or a disclaimer of opinion, as deemed appropriate.

## AAS- 3

## DOCUMENTATION

"Documentation" refers to the working papers prepared or obtained by the auditor and retained by him in connection with the performance of his audit.

1. **Form and Content of working papers** - These are affected by matters such as –
   a. The nature of the engagement
   b. The form of auditor's report
   c. The nature and complexity of the client's business.
   d. The nature and condition of the client's records and degree of reliance on internal controls, and
   e. The need in particular circumstances for direction, supervision and review of work performed by assistants.

2. **Preparation of working papers** - Following care should taken while preparing for working papers -
   a. Working papers should be designed and properly organized
   b. They should be standardized
   c. They should be adequately complete and detailed
   d. All significant matters, which require the exercise of judgment and the auditor's conclusion as regards them, should be included in working papers.
   e. The auditor should ensure that the schedules, analysis and other working papers prepared by the client and utilized in the course of the audit have been properly prepared.
   f. In case of recurring audits, some working paper files may be classified as permanent audit files and current audit files.

3. **Contents of permanent Audit file –**
   a. Information concerning the legal organizational structure of the entity, such as Memorandum and Articles of Association in case of a company, and relevant regulations in the case of a statutory corporation.
   b. Extracts or copies of important legal documents, agreements and minutes relevant to the audit.
   c. A record of the study and evaluation of internal controls related to the accounting system.
   d. Copies of audited financial statements of previous years.
   e. Analysis of significant ratios and trends.
   f. Copies of management letter, issued by auditor, if any:
   g. Record of communication with the retiring auditor, if any, before the acceptance of the appointment as auditor.
   h. Notes regarding significant accounting policies.
   i. Significant audit observations of earlier years.
   j. List of officers, their financial powers and authorities.
   k. List of offices, factories, godowns, depots etc.

4. **Contents of current audit file**
   a. Correspondence relating to acceptance of annual reappointment.
   b. Extracts of important matters in the minutes of Board meetings and general meetings, as are relevant to audit.
   c. Evidence of the planning process of the audit and audit programme.
   d. Analysis of transactions and balances.
   e. A record of nature, timing and extent of auditing procedures performed, and the results of such procedures.
   f. Evidence that the work performed by assistants was supervised and reviewed.
   g. Copies of communication with other auditors, experts and other third parties.

h. Letters or representation or confirmation received from the client.

i. Copies of letters or notes concerning audit matters communicated to or discussed with the client, including the terms of the engagement and material weakness in relevant internal controls.

j. Conclusions reached by the auditor concerning significant aspects of the audit.

k. Copies of the financial information being reported on, and the related audit reports. .

I. Reports of branch auditors, internal. auditors and stock auditors etc.

**5. Ownership and Custody of Working Papers**

Working papers are the property of the auditor. He may, at his discretion, make any portions or extracts from his working papers available to the client. The auditor should adopt reasonable procedures for custody and confidentiality of his working papers and should retain them for a time sufficient to meet the needs of his practice and satisfy any pertinent legal or professional requirements of records retention.

**W.e.f 01/04/2005 Onwards**

- It is to be considered in auditing of financial information.
- Sufficient & appropriate documentation to provide a record of basis for auditors report and to demonstrate that audit was performed in accordance with AAS and applicable legal and regulatory requirements.
- Documentation (working papers) is the record of audit procedures performed, relevant audit evidence obtained & conclusions the auditor reached.
- It may be recorded on paper or electronic or other media.
- Audit documentation for a specific audit engagement is assembled in an audit file.
- ***Purpose of A.D:-***

  (i) Assisting Audit team to plan & perform the audit

  (ii) Assisting members of audit team to direct / supervise the work etc as per AAS-17.

  (iii) Demonstrating the accountability of Audit team for its work.

  (iv) Retaining a record of matters of continuing significance to future audits of the entity.

  (v) Enabling an experienced auditor to conduct reviews as per statement on Peer Review.

  (vi) Enabling an experienced auditor to conduct external reviews as per applicable legal or other requirement.
- ***Form, Content and Extent of Audit Documentation:-***

  Auditor should prepare documentation that enables an experienced auditor, having no previous connection with the audit, to understand.

  (vii) Nature, timing, extent (NTE) and results of Audit procedures

  (viii) Audit Evidence obtained

  (ix) The conclusions reached on significant matters.

  (x) In relation to audit procedures designed to address identified risk of material misstatements, conclusions that are not otherwise readily determinable from the documentation of procedures or evidences.
- Auditor to document (a) Oral discussion and (b) Management response.
- If auditor has identified audit evidence that contradicts / is inconsistent with auditor's final conclusion regarding a significant matter, he (auditor) should document how he addressed the contradiction.
- Audit to record

(i) Who performed the audit work & date of such work

(ii) Who reviewed specific audit documentation & date of such review.

- Auditor should record the identifying characteristics of the specific items tested.

- If in exceptional circumstances, auditor departs from basic principle or procedure in an AAS, he should document the reasons for the same.

- 滚 After date of audit report, if (in exceptional situations) auditor performs new procedures etc. he should document the changes necessary including:

  (i) When & by whom such charges were made & reviewed (if applicable)

  (ii) Specific reasons for the changes, &

  (iii) The effect (if any) of changes on auditors conclusion.

- 滚 After completing Audit file, auditor shouldn't delete any documentation. However he may make addition he should take care of above, same is the case with documentation of new information received after A.R's date.

- Auditor, should (regarding documentation)

  (i) Maintain its confidentiality & sale custody.

  (ii) Protect its integrity

  (iii) Enable its accessibility & retrievability, &

  (iv) Enable its retention for a period sufficient to meet the needs of the firm & legal and professional requirements (subject to legal requirements but not shorter than 10 years from date of audit report).

- He should adopt proper control procedures to maintain integrity, accessibility and retrievability of data whether documentation is in paper, electronic or other media.

# AAS- 4

## THE AUDITOR'S RESPONSIBILITY TO CONSIDER FRAUD AND ERROR IN AN AUDIT OF

## FINANCIAL STATEMENTS

1. **Fraud -** fraud refers to intentional misrepresentation of financial information by one or more individuals among employees, management, those charged with governance, or third parties. A fraud may involve
   a. Manipulation or falsification of accounting records
   b. Misappropriation of assets
   c. Suppression or omission *of* effects of transactions from records or documents
   d. Wrong accounting procedures
   e. Misapplication of accounting policies

2. **Error** - It refers to unintentional mistakes in financial statements. For e.g.
   a. Mathematical or clerical mistake
   b. Oversight or misrepresentation of facts
   c. Misapplication of accounting policies

3. **Responsibility for detection of fraud and error** - Prevention and detection of fraud and error is the responsibility of the management, and for this purpose it should implement and continuously operate an adequate system of internal control.

   The audit should be planned in such a way that there is reasonable expectation of detecting material misstatement in the financial information resulting from fraud and error

4. **Inherent Limitations of an Audit**
   a. The test nature of an audit will involve judgement as to the areas to be tested and the number of transactions to be examined.
   b. Audit evidence in many cases is persuasive, and not conclusive
   c. Material misstatements resulting from frauds are more difficult to detect than those resulting from errors because frauds will usually involve acts with a view to conceal frauds.
   d. Audit programme is drafted only to help the auditor -to achieve the objective of framing and expressing an opinion on financial statements.

      If the auditor adheres to basic principles governing an audit, e.g. Performance of audit work with requisite skill and competence, he will not be responsible for any subsequent discovery of material misstatement in financial information resulting from fraud or error.

5. **Discussion and inquiries** - In planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the entity to material misstatements in the financial statements resulting from fraud or error. In addition the auditor should make inquiries of the management regarding the accounting and internal control system in place to prevent and detect error. In order to obtain insights regarding the susceptibility of the entity to management fraud, the auditor should seek the views of those who are charged with governance on the adequacy of accounting and internal control systems in place to prevent and detect frauds and error, the risk of frauds and error and the competence and integrity of management.

6. **Audit Risk** - When assessing inherent risk and control risk in accordance with AAS-6, the auditor should consider how the financial statements might be materially misstated as a result of fraud or error. Based on his assessment of inherent and control risk, the auditor should design substantive procedures to reduce to an acceptably low level the risk that misstatements resulting from fraud and error that are material to the financial statements taken as whole will not be detected.

7. **Procedures when circumstances indicate a possible misstatement –** When the auditor encounters circumstances that indicate presence of material misstatements resulting from fraud

and error, the auditor should perform procedures to determine whether the financial statements are materially misstated. When the auditor identifies a misstatement, he should consider whether such a misstatement might be indicative of a fraud and if there is such an indication, he should consider the implication of the misstatement in relation to other aspects of the audit, particularly the reliability of management representation.

When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated due to fraud or error, he should consider a necessity for a disclosure in the financial statements and if adequate disclosures are not made, the necessity for a suitable disclosure in audit report.

8. **Documentation -** The auditor should document fraud risk factors identified and his response to such factors.

9. **Management representation -** The auditor should obtain a management representation that
   a. It is responsible for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error;
   b. It believes that the effect of uncorrected misstatements, both individually and in aggregate, is immaterial;
   c. It has disclosed to the auditor all facts relating to frauds or suspected frauds known to the them; and
   d. It has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud or error.

10. **Communication -** When the auditor identifies a misstatement resulting from fraud or error, ,he should communicate that information to the appropriate level of management on a timely basis, and consider the need to report such matters to those charged with governance and if required to regulatory and enforcement authorities. The auditor should communicate to the management any material weakness in internal control related to the prevention or detection of fraud and error, which has come to his attention as a result of the performance of the audit.

11. **Auditor unable to complete the engagement -** If the auditor concludes that it is not possible to continue performing the audit due to material misstatements, he should consider the professional and legal responsibilities applicable in the circumstances including responsibilities to persons who made the audit appointment or regulatory authorities. The AAS specifies that in such circumstances the auditor should consider the possibility of withdrawal from the engagement .The AAS also specifies that if fraud or suspected fraud was a factor in the existing auditor's withdrawal from the engagement, the existing auditor should estate the facts relating to these matters to the incoming auditor.

## AAS – 5 AUDIT EVIDENCE

**Sufficient and Appropriate :** Sufficiency refer to quantum of evidences, whereas appropriateness refer to quality. Evidences should be seen in totality.

**Obtaining the Evidences** **Procedures**

**Compliance**
Whether internal control have been designed and these are operating effectively throughout the period.

**Substantive**
Regarding completeness, accuracy and validity of transactions and balances.

**Reliability of Evidences :**

- ⇒ External Evidences more reliable.
- ⇒ Internal Evidences reliable if internal controls are effective.
- ⇒ Written are more reliable than oral.

**Consistency :** If evidences from one source are inconsistent with those obtained from other sources, auditor is required to perform extended procedures.

**Methods :**

a. **Inspection –** It involves examination of records, documents or assets, etc.
b. **Computation –** i.e. to check the arithmetical accuracy of data and records.
c. **Analytical Review Procedures –** Examination of significant ratios and trends.
d. **Inquiry and confirmation –** obtaining appropriate informations from persons orally or In written form.
e. **Observation –** witnessing a process being performed by others.

## AAS- 6
## RISK ASSESSMENT AND INTERNAL CONTROLS

According to this standard, it is the responsibility of the management to develop and operate. an adequate. system of accounting and internal control. The auditor should acquaint himself with the accounting system and internal control system in order to develop an effective audit plan. The auditor should use his professional judgment to assess audit risk and to design audit procedures to ensure that it is reduced to an acceptably low level.

1. **Accounting System** - Accounting system refers to the series of tasks and records of an entity by which transactions are processed as a means of maintaining final records. The auditor should obtain an understanding of the accounting system sufficient to identify and understand
   a. Major classes of transactions;
   b. Manner of initiation of transaction;
   c. Significant accounting records, supporting documents and specific accounts in the financial statements; and
   d. The accounting and financial reporting process.
2. **Internal Control System** - It refers to all the policies and procedures adopted by the management of the entity to assist in achieving management's objective of:
   a. Conducting the business in an orderly and effective manner;
   b. Adherence to management policies.
   c. Safeguarding of assets; and
   d. Defection of fraud and error in a timely manner

   **"The Internal Control System comprises of**

   **i. The Control Environment -** It refers to the overall attitude, awareness and actions of the directors. and management regarding the internal control system and its importance in the entity.

   **II. Control Procedures -** Control procedures are additional policies and procedures established by the management to achieve entity's specific objectives. These procedures include preparation of periodic reports, approving and controlling access to documents and records etc.
3. **Audit Risks -** Auditors risk is the risk that the auditor may give an inappropriate opinion when the financial statements are materially misstated. Audit risk has three components viz.; inherent risk, control risk and detection risk.-
4. **Inherent Risk -** Inherent risk is the susceptibility of an account balance or class of transaction to a material misstatement either individually or when aggregated with misstatements of other balances or classes, assuming that there were no internal controls. The auditor should study and evaluate the degree of inherent risk in order to determine the audit plan. He should also consider other factors, which might compensate for an otherwise high degree of inherent risk.

   **Inherent Limitations of Internal Controls**

   The objectives of internal control can only be reasonably, and not absolutely, achieved due to the following limitations inherent in the system:
   a. Management's concern about the operating system;
   b. Transactions of unusual nature may be missed by most controls;
   c. Potential of human error;
   d. Circumvention of controls through collusion;
   e. Abuse of control by the person who is himself responsible for exercising it; f. Inadequacy of procedures due to changes in conditions; and
   g. Manipulations by management.

5. **Control Risk.-** Control risk is the risk that a misstatements could occur in an account balance or class of transaction and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected and corrected on a timely basis by the accounting and internal control system.

   I. **Preliminary Assessment of Control Risk**
   In order to make a preliminary assessment of the control risk, the auditor should obtain an understanding of the accounting system and related internal controls.

   The preliminary assessment of control risk 'is the process of evaluating the likely effectiveness of an entity's accounting on internal control system in preventing or detecting and correcting material misstatements. Thus the auditor should assess the control risk as high when

   a. The entity's accounting and/or internal control system are/is not effective; or
   b. It would be inefficient to evaluate the effectiveness of the accounting and internal control system.

   II. **Test of Controls**
   Tests of controls are performed by an auditor to obtain audit evidence about the effectiveness of the

   a. Whether the accounting and internal control systems are suitably designed to prevent or detect and control material misstatements; and
   b. Operation of internal controls throughout the period. '

   Test of control may include the following procedures:

   - Inspection of the documents and records;
   - Inquiries about and observation of internal controls that leave no audit trail;
   - Re-doing on a test basis, activities performed automatically by the system; and
   - Testing of internal controls operating on computerized applications.

   III. **Final assessment of control risk**
   On the basis of the results of the test of control the auditor should evaluate whether the preliminary assessment of control risk was correct or do they need to be revised. He should accordingly determine any modification in the nature, timing and extent of audit procedures.

6. **Relationship between assessment of Internal and Control Risks -** The auditor should make a combined ,assessment of the inherent and control risks. This is because the management often reacts to inherent risk situations by designing suitable accounting and internal control system to prevent or detect and correct material misstatement.

7. **Detection Risk -** 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, either individually or when aggregated with misstatements in other balances or classes.

   There is an inverse relationship between detection risk and the combined level of inherent and control risks. Thus when inherent and control risks are high, acceptable detection risk should be low to reduce the audit risk to an acceptably low level. It should, however, be noted that the assessed levels of inherent and control risk cannot be sufficiently low to eliminate the need to perform substantive procedures.

   When the auditor determines that the detection risk regarding material assertion in the financial statements cannot be reduced to an acceptably low level, the auditor should express a qualified opinion or a disclaimer of opinion as may be appropriate.

8. **Internal Controls In a Small Business** - There may be inadequate segregation of functions among a small number of persons who perform accounting procedures.. However through an effective supervision by the owner or manager of the business who has direct personal knowledge of the business and its transactions, this limitation can be neutralized. But where effective supervision is lacking, the auditor should largely depend upon subtractive procedures to form his opinion as regards financial information.

9. **Communication of Weaknesses in Internal Control** - Any material weakness in the internal control noticed by the auditor during the course of his evaluation or audit procedures should be communicated in writing to the management in a timely manner. However, such communication should make it clear that the audit examination has not been designed to determine the adequacy of internal controls.

## AAS- 7

## RELYING UPON THE WORK OF AN INTERNAL AUDITOR

Though work of internal auditor can be useful to the statutory auditor, the statutory auditor alone will be responsible for his report and for determination of the nature, timing and extent of the auditing procedures.

**Scope and Objective of Internal audit function:**

It depends on the size and structure of the enterprise and the requirements of its management. The internal audit broadly covers following areas:

a. Review of accounting system and internal controls
b. Examination for management of financial and operating information.
c. Examination of the economy, efficiency and effectiveness of the operations.
d. Physical examination and verification.

**Relationship between internal and external auditors:**

a. Although the internal and external audit functions are different as regard their role and objectives, the external auditor can usefully draw on the work of internal auditor to determine the nature, timing and extent of the auditing procedures.
b. However, the external auditor should carefully subject the relevance of the internal control system to his own examination.
c. The external auditor will alone be responsible for his report and the reliance on the internal auditor's work will in no way reduce his responsibility.

**General evaluation of Internal audit function:**

The external auditor's evaluation and conclusions as to the internal audit function should take into account the following:

**a.** **OrganIsational status :** Whether the internal auditor reports directly to top management and is free of any other operating responsibility, whether there are any restrictions as regards the work of the internal auditor should be evaluated by external auditor.

**b.** **Scope of coverage:** The nature and depth of coverage of the internal auditor's assignment vis-a-vis the management should be ascertained and how the management acts upon his recommendations.

**c.** **Technical competence:** Whether the internal audit is under the charge of persons with appropriate professional training and proficiency should be considered.

**d.** **Due Professional care:** Whether the internal audit function is property planned, supervised" reviewed and documented should be ascertained.

**Coordination:** When the internal auditor's work is to be relied upon. The external auditor should ascertain the internal audit plan and discuss with him at an early stage to determine the areas where reliance may be placed. The internal. and external auditors should meet at regular intervals to ensure effective coordination. They should share the information, which may help each other.

**Evaluating specific internal audit work:**

He should review the internal auditor's work taking into account the following factors

a. The scope of work and related audit programme are adequate for the external auditor's purpose.
b. The work was properly planned and the work of .assistants was properly supervised, reviewed and documented.
c. Sufficient appropriate evidence was obtained.
d. Conclusions reached are appropriate in circumstances and any report_ prepared are consistent with the results of the work performed.
e. Any exceptions disclosed by the internal auditor's procedures are properly resolved.

The external auditor's conclusions as to the review of the specific work should be documented. He should also test the work of the internal auditor on which he intends to rely. The nature, timing and extent of his tests will depend on his evaluation of internal audit function.

## AAS- 8
## AUDIT PLANNING

The first step in audit process is planning. Every audit should be carefully planned to ensure highest technical standards make best use of audit personnel and achieve utmost efficiency. Audit plan helps to:

a. Ensure that appropriate attention is devoted to important areas of audit.
b. See that potential problems are promptly identified.
c. Ensure that work is completed on time.
d. Coordinate the work done by other auditors and experts.
e. Utilize the assistants properly.

**Factors to be considered while planning the audit are:**

a. Complexity of the audit.
b. Environment in which the entity operates.
c. Previous experience with the client.
d. Knowledge of client's business.

**Knowledge of the client's business:** It will enable the auditor to identify the events, transactions and practices, that in his judgment, may have a significant effect on the financial information. The auditor can obtain such knowledge from:

a. the client's annual report to its shareholders;
b. minutes of meetings of shareholders, Board of Directors etc;
c. internal financial management reports;
d. previous year's audit working papers;
e. discussion with client;
f. the client's policy and procedures manual;
g. consideration to the state of economy and its affect on client's business; and h. visit of the client's premises and plant facilities.

**Development of an overall plan:** The overall plan should cover the following:

a. Terms of audit engagement and statutory responsibilities.
b. Nature and timing of reports or other communication.
c. Relevant legal and statutory requirements.
d. Accounting policies of client and changes therein.
e. Effect of new accounting or auditing pronouncements on the audit.
f. Identification of critical audit areas.
g. Conditions requiring special attention.
h. Degree of reliance as regards accounting system and internal control.
i. Possible rotation of emphasis on specific audit areas.
j. Nature, timing and extent of audit evidence to be obtained.
k. Work of internal auditors and reliance to be placed on them.
l. Consideration to branch auditor's report.
m. Allocation of work between joint auditors and the procedures for its control and review.
n. Establishing and coordinating the staff requirements.

**Developing the audit programme :**

The auditor should prepare a written audit programme setting forth the procedures that are needed to be implemented while carrying out the audit plan. He may take into account the reliance to be placed on internal controls.

The auditor has some flexibility in deciding when to perform audit procedures. But, sometimes he may have no discretion as to timing, such as, observing the stock taking by the client's personnel. The audit programme should consider previous year's audit programmes and should be modified, if necessary.

# AAS- 9

## USING THE WORK OF AN EXPERT

An auditor during the course of an audit may have to place reliance on the work of an expert. An expert is a person who possesses special skill, knowledge: and experience in a particular field, other than accounting and auditing.

**Determining the Need to use the Work of an Expert:**
During the audit, an auditor may seek to obtain, either independently or from the client, audit evidence by way of reports, opinions, valuations and statements of experts, such as value of certain types of assets, actuarial valuation etc. In determining whether to use the work of an expert, the auditor should consider the materiality of an item, the nature and complexity of item etc.

**Skills and Competence of Expert :**
The auditor should satisfy himself regarding the expert's skill and competence by considering his professional qualifications, experience and reputation in the field in which the auditor is seeking evidence.

**Objectivity of the Expert :**
The auditor should consider the objectivity of the expert. Such objectivity may be affected if the expert is an employee of the client or is otherwise related to the client.

**Evaluation of the Work of an Expert:** ,
The auditor should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information. He should see whether the expert has used the source data, which are appropriate in the given circumstances. He should also obtain an understanding of various assumptions and methods used by expert to determine their reasonableness. In case the work of the expert does not support the related representation in the financial statement, the auditor should attempt to resolve the inconsistency_by discussions with the client' and the expert. He may apply additional procedures, including engaging another expert.

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

**Reference to Expert in Audit Report :**
In case of an unqualified report, the auditor should not refer_to the work of an expert. In case of qualified opinion, he may refer to or describe the work of the expert to explain the nature of his reservation. He, may refer the name of the expert subject to prior consent of the report.

# AAS-10
# USING THE WORK OF ANOTHER AUDITOR

AAS-10 is applicable only to components audits and it excludes joint audit form its purview.

The procedures laid down in AAS-10 are applicable where the financial statement of a component of business, For Example, branch, sales depot etc. are material. Where several components, immaterial in themselves, are together material in relation to the financial statement as a whole, this AAS is applicable.

**COMPONENT** Any branch, division, subsidiary, J.V., or associates etc. whose financial information is used in the financial statements of client.

**Principal Auditor's Procedures:**

The following procedures are recommended on the part of principal auditor:

1. Advise the other auditor of the use that is to be made of his work and report.
2. The principal auditor should also inform the areas requiring special consideration and the timetable for completion of audit.
3. Advise the other auditor of the significant accounting auditing and reporting requirements.
4. Ascertain from other auditors any limitation on the scope of his work by the terms of engagement.
5. Consider the significant findings of the other auditor.
6. The principle auditor is not required to evaluate the professional competence or independence of other auditor except in doubtful situation,
7. He may require the other auditor to submit responses to a questionnaire regarding the audit work performed.
8. He may discuss with the other auditor and concerned branch official the audit findings affecting the financial statements of the branches.
9. If necessary, he may require that supplementary tests be performed or he may himself perform such tests.
10. In case of foreign branch, the principal auditor should consider the qualification, experience and expertise of the foreign branch auditor.

**Documentation:**

1. The principal auditor should maintain in his working paper / files the financial statement of the branches, which are audited by other auditor. He should also document the manner in which he has applied the audit procedures and conclusions thereof.
2. When the other auditor has qualified his audit report, the principal auditor should refer in his working paper the manner in which he dealt with the same.

**Coordination between Auditors:**

1. There should be coordination between the principal auditor and branch auditor so what they can discharge their responsibility effectively.
2. The other auditor should bring to the notice of principal auditor any of his significant findings, adhering to the time scales, ensuring compliance with legal requirements, etc.
3. If the principal auditor requires a specific audit procedure to be carried out or to answer a detailed questionnaire, the other auditor should comply with the same.

Consideration of Report of Other Auditor

1. The principal auditor should qualify or disclaim his opinion when he concludes that he cannot use the work of the other auditor and has not been able to perform sufficient additional procedures with respect to the financial statements submitted by the branch auditor.
2. The principal auditor should consider the qualification of the branch auditor's report in relation to the financial statement of the entity as a whole.

**Division of Responsibility:**

1. The principal auditor is not responsible for work carried out by the other auditor unless there are doubtful . circumstances
2. The principal auditor's report should clearly state the division of responsibility by indicating the extent to which the financial statement of branches audited by other auditors have been included in the financial statement of the entity e.g. the number of branches / divisions audited by other auditors.

## AAS – 11 Management Representation

**Management Representation –** written / oral confirmation by them w.r.t. items included in financial statement.

**Example :**

(i) For Financial Statement as a whole.
(ii) For Accounting Policies.
(iii) Investments.
(iv) Provision for claims, etc.

**Types of MRL :**

(i) Letter issued by management.
(ii) Letter from auditor outlining his understanding, duly acknowledged and confirmed by management.

**Elements :**

– Addressed to Auditor.
– Dated and signed by proper authority.
– MRL date $\leq$ AR date.
– For specific transfer there may be separate MRLs.

**Management Representation as Audit Evidence :**

– He should use his professional judgement to decide the areas in which MRL is required.
– Management Representation should be in writing.
– Auditor should seek corroborative evidences.
– Evaluate its reasonableness and consistency.
– Person rendering Management Representation should be well informed.
– Management Representation Letter can't be substitute for other audit evidences.
– Sometimes it may be only evidence.

**Documentation :** of both types of Management Representation Letters.

**Refusal by Management :**

Auditor asks for MRL

Management provides ↓ OK

Management Refuses ↓ Auditor should himself prepare it with a request to acknowledge the same.

Management Acknowledges ↓ OK

Management refuses ↓ Limitation on Scope of work of auditor

## AAS-12

## JOINT AUDITORS

**Division of Work :**

The joint auditors should divide the audit work in anyone of the following basis:

1. Components of financial statements
2. Geographical location
3. Functional areas and activities
4. Period basis

The division of work among joint auditors should be adequately documented and communicated to the entity.

**Coordination among Joint Auditors:**
Where a company auditor comes across matters, which are relevant to the areas of responsibility of their joint auditors, he should communicate it immediately to the other joint auditors to discharge himself of the responsibility.

**Relationship among Joint Auditors:**
Each joint auditor is responsible for the work allocated to him. However, in respect of following areas, all the joint auditors are jointly and severally responsible.

1. Audit work not divided among joint auditors and carried out by all of them.
2. Matters, which are brought to the knowledge of joint auditors by one of them and on which there is an agreement among the joint auditors.
3. Collective decisions taken by joint auditors such as the decision regarding the nature, extent and timing of the audit procedures to be carried out.
4. Compliance and disclosure requirements as per statute.

In case the information is brought to the other joint auditors by an auditor after submission of the audit report, the other joint auditors would not be responsible for such matter.

Each joint auditor is responsible for drafting his own audit programme and determine nature, extent of checking etc.

Each joint auditor should keep appropriate working papers, which enables him to come to a conclusion regarding the financial statements.

In the case of audit of a large entity with several branches. In such a case, it is the separate responsibility of each joint auditor to review the reports of the branches allotted to him and to ensure that they are properly incorporated into the accounts of the entity.

In respect of branches, which do not fall under any division or zone, which were separately assigned to different joint auditors, they may agree among themselves regarding the division of work relating to such branch returns.

Each joint auditor is entitled to rely upon the work carried by other joint auditors. It is not necessary for a joint auditor to review the work performed by other joint auditors or perform any tests to ascertain whether the work has actually been performed in accordance with generally accepted audit procedures.

If one of joint auditors also carries out the audit of branches or other division of the entity, the joint auditors. are entitled to rely upon the work carried out by him, unless the other joint auditor specifically brings out any material discrepancy.

**Reporting Responsibilities:**
Where the joint auditors are in disagreement with regard to any matter, each one of them should express his own opinion through a separate report. The joint auditor is not bound by the views of the majority of joint auditors regarding matters to be covered in the report.

## AAS – 13 AUDIT MATERIALITY

**Materiality :**

→ Material items are those which may influence the judgement of users of statement.

→ It may be quantitative / qualitative.

→ It depends upon –
(i) Size of item (ii) Nature of item, (iii) Statutory provisions, etc.

→ Materiality to be considered from both point of views –
(i) Individual A/c.; and
(ii) Overall financial statement.

→ Auditor to consider materiality while –
(i) Determining NTE of audit procedure; and
(ii) Evaluating effect of misstatement.

***Relationship between Materiality and Audit risk***

→ Degree of audit Risk and Materiality Level.

**Reason** – Generally management / employees don't commit fraud in high value items. Moreover, as a general practice, auditor checks high value items in detail. Thus it is less risky that high value F & E may not be detected. Thus high materiality level leaves audit risk at lower degree. Thus inverse relation.

**Procedure and considerations by Auditor –**

→ Auditor decides upon mat level during planning stage which may be *changed* during progress of audit. May be increased/decreased for specific A/c.

→ If ARP indicates misstatements, auditor should adopt other procedures to estimate it.

→ Aggregate uncorrected misstatement =
(i) Specific misstatement identified by Auditor +
(ii) Aggregate uncorrected misstatements (not identified) +
(iii) Net effect of uncorrected misstatement identified during previous year's audit.

→ Auditor concludes aggregate uncorrected misstatement are material
↓
Ask management to adjust f. st.

| Mgt. does | Mgt. refuses |
|---|---|
| ↓ | ↓ |
| OK | qualify / adverse |

## AAS-14
## ANALYTICAL PROCEDURES

"Analytical review procedure" refers to analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviates from predicted amounts. The auditor should apply analytical review procedures at the planning and the overall stages of audit.

**Nature and purpose of Analytical Procedures:**

Analytical review procedures includes both inter-firm and intra firm comparisons. The latter is vis-a-vis:

a. Comparable information for prior periods.
b. Predictive estimates prepared by auditor e.g. estimation of depreciation change.
c. Anticipated results of the entity such as budgets or forecasts.
d. Similar industry information - entity's ratio of sales to debtors with industry averages.

It depends on the auditor's judgment as to the nature of procedures, methods arid level 6f applications.

**Purposes / stages of application of Analytical Review Procedures:**

The analytical review procedures can be used by the auditor for the following purposes / at following stages:

i. While planning the nature, timing and extent of other audit procedures.
ii. As a means of substantiating the financial assertion relating to business transactions.
iii. Overall review of the financial statements in the final review stage of the audit.

**Stage I - Planning the audit:**

Analytical review procedures assist in understanding the business and in identifying areas of potential risk. It may indicate aspects of the business of which the auditor was not aware,

**Stage II - Analytical review tasks as useful substantive procedures:**

The following are the factors that need to be considered while applying analytical procedures as substantive tests:

1. Extent of reliance that can be placed on analytical procedures and results derived thereof.
2. Nature and complexity of the business.
3. Reliability of information available
4. Relevance of information available.
5. Sources from which information is available i.e. internal/external sources.
6. Comparability of the information available.
7. Knowledge gained by the auditor in the previous year's audit.
8. Auditor's understanding of the effectiveness of the accounting and internal control systems and types of problems that in prior periods have given rise to accounting adjustments.

**Extent of reliance that can be placed on Analytical Procedures:**

The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:

1. Materiality of the items involved..
2. Other audit procedures directed towards the same audit objectives e.g. other procedures performed by the auditor in reviewing the collectability of accounts receivable.
3. Accuracy with which the expected results of analytical procedures can be predicted.
4. The auditor should also test the control over the preparation of information used in applying analytical procedures.

**State III - Overall review at the end of the audit:**

The auditor should apply analytical procedures at the end of the audit when of in overall conclusion as to the consistency financial statement with that of auditor's knowledge of the business. The drawn thereof is intended to corroborate the evidences found during the audit of individual element or components, of the financial statement. Where, based on analytical pr ocedures, the auditor concludes that he has to apply further procedures before forming conclusions, then he has to apply such procedures which he considers deemed fit.

**Investigation of unusual items:**

When analytical procedures identify major fluctuations or relationships that are inconsistent with other relevant information, the auditor should investigate and seek explanation from management and other corroborative evidences.

# AAS – 15
# AUDIT SAMPLING

**Sample DUS METER**

**Audit Sampling –** *Meaning* – Application of audit procedure on *Less than 100%* of items within a class of tr./A/c. Balance

→ It may be *statistical* or *non-statistical*.

→ It requires *skill and competence* on part of auditor.

→ Auditor should try his level best to choose sample which should be *true representative* of population.

→ Choosing all items above certain amount is not sampling.

**Design of Audit Sample –** It depends on following :

(i) *Audit Objective* – Specific objective and procedures.

(ii) *Population* – It should be appropriate.

(iii) *Stratification* – Dividing *heterogeneous* (different characteristics) population in more *homogeneous* (similar characteristics) sub-population. For getting same level of assurance, it results in smaller sample size.

**Sampling Units –** Individual units constituting the population.

**Size of Sample –** Auditor should consider overall population, tolerable error, expected error and sampling risk.

**Method of Sampling –** Each item in population should have equal chances of being chosen. Thus –

(1) *Random Sample* – use of random no table. Each sampling unit has equal probability of being selection.

(2) *Systematic Sample* – Having fixed interval, between any consecutive units selected. However, it can be adopted only when population is not structured in a way that it corresponds to a particular trend.

(3) *Haphazard Selection* – No intention to include/exclude a particular item. Equivalent to (1).

**Expected Error -** If auditor *expects error* in sample – *larger* sample size, otherwise smaller sample size.

**Tolerable Error –** *Maximum Error* in population that auditor is ready to accept for a given sample size.

**Evaluation of Sample Results –** *Steps* are as follows :

**I$^{st,}$ Step – Analysis of Error in Sample –**

– Judge whether an item is error or not.

– If sufficient and appropriate evidence can't be obtained regarding a specific item, it could be an error.

– Auditor to check < cause of error and its impact on other phases of audit.

– Common trend in error → extended procedures.

**II$^{nd}$ Step – Projection of Error –**

– Project it to entire population by appropriate method.

– Consider both quantitative and qualitative aspects of error found while projecting.

**III$^{rd}$ Step – Reassessing Sampling Risk –**

– If error in population > tolerable error;

– Either revise sampling risk or extend audit procedure.

**Sampling Risk -** It arises from possibility that auditor's conclusion based upon sample may be different from conclusion that would have been reached if complete population were subjected to same audit procedure.

- If auditor willing to accept less risk → large size of sample to be chosen.
- It is always there in sampling..

**Sampling Risk**

| | | |
|---|---|---|
| In Compliance Procedure | Risk of under reliance | Risk of over reliance |
| In Substantive Procedure | Risk of incorrect rejection | Risk of incorrect acceptance |
| | → Less risky<br>→ Leads to more work to be performed by auditor | → More risky<br>→ May lead to erroneous opinion by auditor. |

## *AAS – 16*
## *Going Concern*

**Going Concern :** an entity is said to be going concern if it is likely to continue in existence for foreseeable future.

⇒ It is a fundamental accounting assumption (AS-1).

**Auditor's Consideration :** whether going concern assumption adopted by management holds goods.

⇒ There may be indicators when auditor should adopt extended procedures.

**Indicators :**

| Financial | Operating | Other |
|---|---|---|
| 1. Negative net worth/working cap. | 1. Loss of key management .without replacement. | 1. Pending legal proceedings |
| 2. Arrears / discontinuance of Dividends | 2. Loss of major market or or supplier. | 2. Change in Govt. Policy affecting the entity adversely. |
| 3. Adverse financial ratio | 3. Labour unrest strikes etc. | 3. Non-compliance with Statutory requirements |
| 4. Substantial losses (operating). | 4. Loss of major licence, franchise, etc. | |
| 5. Borrowings approaching maturity but no prospects of renewal / repayment | | |
| 6. Short term borrowing for long term asset financing. | | |
| 7. No payment to creditors on due date. | | |
| 8. No compliance with terms in loan agreement. | | |
| 9. Negative cash flow from operation. | | |
| 10. Rearrangement with creditors for reduction liability. | | |
| 11. Change from creditors to cash on delivery transaction with supplier. | | |

⇒ Such indications may be mitigated (compensating) by some positive factors. For example – labour difficulties may be solved by negotiations and compromises, or loss of some major supplier may be compensated by availability of some alternate source of supply.

⇒ But in case of question regarding going concern, auditor should obtain sufficient and appropriate evidence *e.g.*

1) Discussion with management.
2) Reviewing events after Balance sheet date.
3) Taking legal advice.
4) Analyse future plans of management.

**Audit procedures – Conclusion and Reporting**

If doubt regarding Going Concern Assumption

↓

Obtain Audit Evidence

↓

Evaluate those Evidences & Conclude whether

↓

**Going Concern is Appropriate**

- Due to Mitigatory Factors
  ↓
  auditor considers whether it needs to be disclosed in financial statements by the management
  If
  - Yes
    ↓
    Ask mgt. to disclose the same
    - If mgt. do not disclose
      ↓
      qualify the report
    - If mgt. discloses
      ↓
      clean report/ modified (disclosure)
  - No
    ↓
    clean report
- Otherwise
  ↓
  clean *report*

**Going concern is inappropriate**

The effect is material and pervasive

↓

Adverse report

**Going concern question is not resolved**

Whether financial statements disclose such fact

- Yes
  ↓
  Normally clean report (But he may provide disclosure in his audit report as well)
- No
  ↓
  Modified report (qualify

21. On 30th September, 2000 a company's issued and paid up capital was Rs.25 crores comprising of fully paid equity shares of Rs.10 each. This included Rs.50,00,000 capital issued for cash; Rs.4,50,00,000 capital issued for purchase of business; Rs.20 crores on issue of bonus shares from time to time by capitalizing various reserves including Rs.5 crores by capitalizing capital redemption reserve. The company had fixed assets costing Rs.2 crores on which depreciable provision was Rs.1.95 crores, which was equal to the full cost of depreciable assets. The balance Rs.5 lakhs represented the cost of land. It has discontinued its operations for last many years. The company had made investments in various companies to the tune of Rs.30 crores. Unfortunately, all the investee companies have turned out to be BIFR cases. Nothing is expected to be realized on such investments. The company has dues from customers totaling to Rs.4.95 crores of which Rs.4.90 crores are due from businesses, which have become defunct. The balance Rs.5 lakhs are due for over 3 years. The accumulated losses are Rs.10 crores. The

amounts due to suppliers are Rs.3 crores and they are overdue. The balancing figure in the Balance Sheet refers to loan from Financial Institutions. Workers who had put in long years of service have lodged claims for termination benefits of Rs.10 crores, which have been decreed in their favour. No accounting entry has been passed for the same since the decree on 1-1-1997. In the light of AAS-16, relating to Going Concern, you are asked to write appropriate paragraph of audit report. Give reason for supporting your report. *(C.A. Final, Nov., 2000)*

**Ans.:** Considering these indicators and as per the facts of the case, the company is not a going concern as on September 30,2000 on account of following reasons :

(i) The company has discontinued its operations for last many years. Its productive fixed assets are fully depreciated. The only productive asset left is land worth Rs.5 lakhs.

(ii) The claim of workers for termination benefits amounting to Rs.10 crores though decreed on January 1, 1997 has not been provided for in the books of account. The accumulated loss of the enterprise would be much higher if these losses were provided for.

(iii) The amounts recoverable from customers totaling Rs.4.95 crores of which Rs.4.90 crores are due from business which are totally defunct are doubtful of recovery in its entirety. Even the balance amount is due for more than 3 years.

(iv) The company has not been able to pay to its suppliers amounting to Rs.3 crores which are overdue.

(v) The company's investment to the tune of Rs.30 crores are not realizable and are worthless in view of the fact that all investor companies have turned sick. The accumulated loss of the enterprise would be much higher if the loss on account of diminution in value of investment was provide for.

(vi) The balance figure for term loan from financial institutions works out to be Rs.17 crores as per records which the company is unable to pay.

(vii) The net worth of the company is completely eroded and there are no mitigation factors or any support from the group company or financial institution that would prevent its ultimate collapse.

Thus, in view of the aforesaid financial operating and other indicators, the assumption of going concern is not appropriate. Since the qualification is very material and all pervasive an adverse opinion rather than a 'subject' to qualification would be required.

Paragraph in the Audit Report. "The Company has discontinued its operations for last many years and has not been able to honour its obligation t creditors and financial institutions for quite some time. Thus total accumulated losses are Rs.54.5 crores (and not as………… Reported).

After taking into account the above factors we are of the opinion that the company is not a going concern as on September 30, 2000 and, thus the using of going concern assumption in the preparation of financial statements is inappropriate.

In our opinion, considering the information given in preceding paragraph, the financial statements do not give a true and fair view of the financial position of the company at September 2002 and the results of its operations for the year that ended".

## AAS- 17
## QUALITY CONTROL FOR AUDIT WORK

**Objective** - To establish standards on quality control:

a. Policies and procedures of an audit firm for audit work generally, and
b. Procedures regarding the work delegated to assistants on an individual audit.

**Meaning of certain terms**

a. Auditor -' The person with final responsibility for the audit.
b. Audit firm - A proprietary or a partnership firm providing audit service.
c. Personnel - All partners and professional staff engaged in the audit practiced of the firm.
d. Assistants - Personnel involved in an audit other than auditor.

**Implementation of Quality Control** - The audit firm should implement quality control policies to ensure that all audits are conducted in accordance with Auditing and Assurance Standard (AASs).

**Essential factors for incorporating quality control in audit work** - .

a. Professional Requirements - Adherence to basic principles such as independence, integrity, objectivity, confidentiality, etc.
b. Skills and competence - Audit personnel should have required degree of skill and competence.
c. Assignment - Audit work should be assigned only to competent personnel.
d. Delegation - There is to be sufficient direction, supervision and review of work at all levels.
e. Consultation - Consultancy within and outside the firm with experts.
f. Acceptance and Retention of clients - Evaluation of prospective client and review of existing client should be done.
g. Monitoring - Continued adequacy and effectiveness of quality control policies should be monitored. The firm's quality control policy should be effectively communicated to its personnel.

**Quality control for Individual Audits** - The quality control policies applicable to firm should be implemented for individual audits to the extent applicable. The audit work should be delegated to assistants with professional competence and should be appropriately directed and supervised. Audit assistants should be informed of the nature of business, accounting policies, possible accounting or auditing problems. They should be explained of what is expected of them and how to achieve it. They should be informed about the importance of audit programme, time budgets and overall audit plan.

**Supervision** - Persons with supervisory responsibilities should

a. Monitor the progress of audit;
b. Become informed of and address significant accounting and auditing questions raised during the audit;
c. Resolve the differences of professional judgment and consider the level of consultation as appropriate.

**Review** - Review of work of audit staff should be carried out to ensure that the:

a. Work has been performed as per the audit programme.
b. Work performed has been adequately documented.
c. All significant matters have been resolved or are reflected in audit conclusions.
d. Objectives of the audit procedures have been achieved, and
e. Conclusions expressed are consistent with the work performed.

**Matters to be reviewed On a timely basis**

a. Overall audit plan and the audit programme.
b. Assessment of inherent and control risks.
c. Changes to be made to audit plan and programme.
d. Documentation of the audit evidence obtained from substantive procedures and the conclusions drawn there from.
e. Any amendment to the financial statement arising out -of the auditor's examination, and the auditor's proposed observations / report.

Persons not connected with audit may be requested to perform additional procedures before issuing the auditor's report.

## AAS-18

## AUDIT OF ACCOUNTING ESTIMATES

**Accounting Estimate -**An approximation of an item in the absence of a precise means of measurement. For example, provision for taxation, provision for warranty claims, provision for a loss from a law suit, accrued revenue etc.

**Responsibility for Accounting Estimates -** Management is responsible for making accounting estimates included in financial statement.

**Nature of Accounting Estimates -** The determination of accounting estimates may be simple or complex, depending upon the nature of the item. Accounting estimates may be determined as part of the routine accounting system operating on a continuous basis, or may be non-routine only at the end of the period. The uncertainly associated with an item, or lack of. objective data may make it incapable of reasonable estimation.

**Audit Procedures -** The auditor should ensure that an accounting estimate is reasonable in circumstance, and when required, is appropriately disclosed in the financial statements. Following approaches should be used in the audit of an accounting estimate

a. Review and test the process used by management to develop the estimate.
b. Use an independent estimate for comparison with that prepared by management, or
c. Review subsequent events, which confirm the estimate made.
d. Obtain external evidence, where possible, to corroborate internal evidence.
e. Evaluate the data and assumptions on which the estimate is based and ensure reasonableness and consistency of assumptions.
f. Use of experts in case of complex estimating process
g. Review the counting appropriateness of formula used by management.
h. Test the calculation procedures used by management.
i. Where possible, compare accounting estimates made for prior periods with actual results of those periods.

**Evaluation of Results of Audit Procedures -** The final assessment of an accounting estimate would be based on the auditor's knowledge of the client's business and its consistency with other audit evidence obtained during the audit. If he of the opinion that the accounting estimates prepared by the management is significantly different from that assesses the auditor, he should request the management to revise the same, If the management refuses to revise the estimate, it would be considered a misstatement and the auditor would need to consider its effect on the financial statements.

## *AAS – 19Subsequent Events*

**Subsequent Event :** Significant events occurring between Balance sheet date and Auditor Report's date.

**Auditors duty and Audit procedures :**

- ⇒ Ensure that all events upto AR date requiring adjustment/disclosure (as per AS-4) in f. statement have been identified and incorporated.
- ⇒ Review management's procedure for identification of sub events.
- ⇒ Inquiring entity's lawyer regarding litigation.
- ⇒ Reading entity's latest interim f.st., budgets. Cash flow statements/forecasts, etc.
- ⇒ Reading minutes of meetings of shareholders, B.O.D. and other executive committees.
- ⇒ Inquiring management about significance of sub events.
- ⇒ If another auditor audits the component of entity, principal auditor should make similar enquiries and procedures w.r.t component regarding events between another auditors report and principal auditor's report.

**Reporting :** If management doesn't agree for such events which as per auditors opinion should be incorporated then qualify / adverse report.

**(31 / 3 – 4 / 6) AS – 4 Events occurring after B/S Date**

| | | |
|---|---|---|
| *Events Confirming* Conditions existed At B/S date | *Events confirming* conditions which arise after B/S date | *Events affecting* going concern |
| ↓ | ↓ | ↓ |
| Adjustment in f. st. | No adjustment. If material, *Then only disclosure.* | Adjusted in *f. st.* |

## *AAS 20 - KNOWLEDGE OF THE BUSINESS*

**Obtaining the knowledge -**

⇒ Auditor should obtain knowledge of the business to identify/understand the events transactions and practices that may have a significant effect on financial statements or audit report.

⇒ General knowledge of economy and industry (level of auditor's knowledge is less than that of management).

⇒ Knowledge at the start of the engagement updation during audit.

⇒ Continuous need for knowledge (knowledge is refined and added in later stages of Audit).

⇒ In continuous engagement, he'll update information to identify significant changes since last audit.

**Sources : For *E.g.*:**

(i) Previous Experience.

(ii) Discussion with people with entity.

(iii) Discussion with internal auditor.

(iv) Discussion with other auditor (Advisor).

(v) Discussion with knowledgeable people outside entity.

(vi) Publication.

(vii) Legislation and Regulation.

(viii) Visits to entity/plant.

(ix) Documents produced by entity (minutes, manuals, plans), etc.

**Knowledge assist him in following :**

i) Assess risk and problems

ii) Plan and perform audit effectively.

iii) Evaluating audit evidence.

Better service to clients.

## *AAS – 21*

### *Consideration of Law and Regulation in an audit of f.st.*

**Non-Compliance :** Act of *commission / omission* by entity (intentional / unintentional), which are *contrary* to prevailing laws or regulation.

- → Management's responsibility to ensure that entity's operations are *conducted as per laws and regulations.*
- → Management's responsibility for *prevention and detection* of non-compliance.
- → Management should –
  - (i) Monitor legal requirements.
  - (ii) Design and operate proper I.C.
  - (iii) Develop publicise and follow code of conduct.
  - (iv) Training to employees.
  - (v) Monitor compliance with code of conduct.
  - (vi) Establish legal department.
  - (vii) Maintain register of significant laws.
  - (viii) In larger entity, to ensure these responsibilities may be assigned to Internal auditor or Audit committee.

**Auditor's Consideration :**

- → Auditor is/can *not* be held *responsible* for preventing non-compliance.
- → The *risk* of non-detention of non-compliance is *higher.*
- → But audit may reveal condition/events compliance.
- → Thus he should accordingly plan and perform audit. For this, he should perform :
  1. He should obtain *general understanding* of (A) Legal and regulatory *framework* applicable to entity and (B) How entity comply with it.
  2. Perform procedures to *identity non-compliance* to be considered when *preparing f.st. specifically.*

     Inquire mgt. as to compliance | Inspect correspondence with relevant authorities
  3. Sufficient and appropriate evidence for compliance with those laws and regulation having effect on material amounts and disclosures in financial statement. (*such laws are known and considered w.r.t. f. st.)*
  - → Except 1, 2, 3, auditor need not test compliance.
  - → However, there may be instances of possible non-compliance came to auditors notice (*fine penalty, etc.)*
  - → Written MRL → that management has disclosed to auditor all known / possible non-compliance effecting preparation of f. st.

**Procedures :** When *non-compliance is discovered :*

- → Understanding nature/circumstances etc. to evaluate possible effect on f.st.
- → Documentation and discuss with management.
- → May consult entity's lawyer.
- → Consider implication of non-compliance w.r.t. other phases of audit (*Reliability of MRL*).
- → If unable to obtain information about suspected non-compliance – consider its effect on A.R.

**Communication / Reporting of non-compliance :**

| To Management | To Users of A.R.<br>If he | To Regulatory Authorities |
|---|---|---|
| → Communicate it to ------- BOD and Senior mgt. | Concludes that Non-compliance has Mat. Effect on f.st.<br>↓<br>qualify/adverse<br><br>Is unable to determine non-compliance due to limitations imposed by<br>Mgt./Entity ↓ Qualify / disclaim<br>or<br>Circumstances ↓ Consider its Effect on AR | Only if required by statute etc. |

**Withdrawal from Engagement :**

→ He may withdraw if management doesn't take remedial steps considered necessary by auditor, even if non-compliance is not material to f.st.

→ He may seek legal advice (*e.g.* Management involvement in non-compliance)

→ When incoming auditor communicates, tell him *reasons* of such withdrawal (not of its affairs)

## AAS – 22 [Initial Engagements – Opening Balance

**Initial Engagements :**

(i) When financial statements are audited for 1st time or
(ii) Some other auditor audited the financial statement for preceding period.

**Opening Balance :**

A/c. Balances existing at beginning of the period *i.e.* closing balance of preceding period b/f to current period.

⇒ It reflects the effect of :

(i) Transaction / Events of preceding period, and
(ii) A/c. policies applied in preceding period.

**Evidence :**

Obtain sufficient app. evidence that :

*(a) Correctly b/f.*
(b) Opening Balance *don't* contain *misstatements* affecting current pd. f.st. and
(c) *Consistent* application of appropriate *A/c. policy*.

**Audit Procedure :**

He should consider :

(i) A/c. policy followed by entity.
(ii) Type of preceding period's. A.R. – clean / modified
(iii) Nature of opening Balance – risk of misstatement.
(iv) Materiality of opening balance for current pd's f.s.t.

⇒ **Financial Statement for preceding period**

*Audited by some other Auditor*

Sufficient App. evidence (for Op. bal.) by having audited financial statement

or

Generally reliance on them

During C.Y. audit, indication of misstatement in opening balance
↓
Extended procedures

*Not Audited*

Extended Procedure
(i) **CA & CL:** Audit Evidence as part of audit procedure during current year.
(ii) **Others :** may check records underlying op. balance or seek external confirmations.

**Audit Conclusion & Reporting :**

⇒ If unable to obtain sufficient app. evidence regarding opening balance – qualified / disclaimer.
⇒ If opening balance contain misstatement affecting C.Y. financial statement and which is not properly incorporated disclosed in financial statement – qualified / adverse.

## AAS-23
## RELATED PARTIES

The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the related party transactions that are material to the financial statements.

**Existence and Disclosure of Related Parties :**

1. He should -
   a. Review the entity's procedures for identification of related parties.
   b. Review his working papers for the prior year for names of known related parties.
   c. Review shareholders records to determine the names of principal shareholders or appropriate, obtain a list of principal shareholders form the share register,
   d. Review the joint venture and other relevant agreements entered into by the entity.
   e. Review statutory records like memorandum and articles of association, minutes of board and shareholders' meetings and other relevant records such as register of director's interest.
2. Where the financial reporting framework requires disclosure of related party relationships, the auditor should satisfy himself that the disclosure is adequate.

**Transactions with Related Parties :**

1. The auditor should review information provided by directors and key management personnel of the entity identifying related party transactions. During the course of the audit, the auditor should carry out detailed procedures, which may identify the existence of transactions with related parties.
2. The auditor needs to be alert for transactions, which appear unusual in the circumstances and may indicate the existence of previously unidentified related parties.

**Examine Identified related party transactions:**

1. In examining the identified related party transactions, the auditor should obtain sufficient appropriate audit evidence as to whether these transactions have been properly recorded and disclosed.
2. Given the nature of related party relationships, evidence of related party transactions may be limited. Because of such transactions, the auditor would consider performing procedures such as:
   a. Confirming the terms and amount of the transaction with the related party.
   b. Obtaining confirmation from persons associated with the transaction, such as, banks, lawyers, guarantors and agents.

**Management Representations:**

The auditor should obtain a written representation from management regarding:

a. The completeness, accuracy and validity of information provided regarding the identification of related parties; and
b. The adequacy of related party disclosure in the financial statements.

**Audit conclusion and Reporting:**

If he is unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties or concludes that their disclosure in the financial statements in not adequate, he should express a qualified opinion or a disclaimer of opinion in his audit report, as may be appropriate.

## AAS-24

## AUDIT CONSIDERATIONS RELATING TO ENTITES USING SERVICE ORGANISATIONS

The Auditor should consider how a service organisation affects the client's accounting and internal control systems so as to plan and develop an effective audit approach.

**Considerations for The Auditor of the Client**

When the services provided by service organisations are limited to recording and processing of transactions of the client and the client retains authorization and maintenance of accountability, the client might be able to implement effective policies and procedures within its organisations. However, the client may have to rely upon the policies and procedures of the service organisation where the latter executes the transactions and maintains accountability on behalf of the client.

While planning his audit, the auditor should determine the significance of activities performed by the service organisation and their relevance to the audit. In doing so the auditor should consider:

- Nature of the services provided.
- Terms of contract.
- Material financial statement assertions that are affected by the use of the service organisation.
- Inherent risks associated with those assertions.
- Extent to which the client's systems interact with those of the service organisation.
- Client's internal controls that are applied to the transactions processed by the service organisation.
- The capability and financial strength of the service organisation.
- Documentation of systems manual of the service organisation.
- Information available on general controls and computer systems controls relevant to the client's application.
- Reports of the auditor or internal auditor of the service organisation.

When the auditor of the client concludes that the activities of the service organisation are significant to the entity and to his audit, he should obtain sufficient understanding of the service organisation's accounting and internal control system. If the information he is able to gather is insufficient, he should consider the need to request the auditor of the service organisation to furnish him information on specified areas.

**Service Organisation's Auditor's Report**

When the auditor of the client uses the report of the auditor of service organisation, he should consider:

a) The professional competence of the reporting auditor; and

b) Nature and content of the report.

The report submitted to the client's auditor would ordinarily be one of the two types as follow:

**Type A - Report of Suitability of Design**

The contents of this report are

a. A description of the service organisation's accounting and internal control System; and

b. An opinion by the service organisation's auditor that

   i. The above description is accurate;

   ii. The systems controls have been placed in operation; and

   iii. The accounting and internal control systems are suitably designed to achieve their stated objectives.

Such reports help the auditor of the client in obtaining an understanding of the accounting and internal control systems installed and operated by the service organisation.

### Type B -Report on Suitability of Design and Operating Effectiveness

The contents of the report are

a. A description of the service organisation’s accounting and internal control systems;

b. An opinion by the service organisation’s auditor that:
   i. The above description is accurate;
   ii. The systems controls have been placed in operation;
   iii. The accounting and internal control systems are, suitably designed to achieve the stated objectives; and
   iv. The accounting and internal control systems are operating effectively based on the results of the tests of control.

In addition to the report on operating effectiveness, the service organisation's auditor should identify the tests of controls performed and their results.

The client's auditor should consider whether the controls tested by the other auditor are relevant to the client's transactions. The client's auditor can also use such reports as an evidence of lower control risk assessment. Based on the control risk assessment, the client's auditor determines the nature, timing and extent of substantive procedures. He may also request the auditor of the service organisation to perform substantive tests in certain areas. However the audit report of the client should not contain reference to the report received from the service organisation's auditor.

## *AAS – 25 COMPARATIVES*

### *COMPARATIVES FINANCIAL REPORTING – FRAMEWORK*

**Comparatives :**

**Corresponding figures**

Amount and other disclosures for preceding Period are included as part of Current year Financial Statement (Applicable in India and thus covered by AAS – 25)

**Comparative f. st.**

Amount and other disclosures for preceding period are included for comparison but not form part of Current year financial statement (Not applicable in India) (Not covered by AAS – 25)

**Auditor's responsibility :**

⇒ Sufficient & Appropriate evidence that corresponding figures meet requirement of relevant financial reporting framework.

⇒ Extent of audit procedure is less for corresponding figures as compared to current period figure.

⇒ He should assess whether –

(ii) *A/c. policies* used for corresponding figures are *consistent* with those of C.Y. figures. (or whether appropriate adj./ disclosure made)

(iii) Corresponding figure *agree* with amount and disclosure in prior period (or whether appropriate adj./ disclosure made) Also take care of AAS – 22.

**Reporting :**

Auditor Report (opinion) is on current period financial statements as a whole, including corresponding figures.

***Auditor's Report on Previous Period***

**Modified**

Auditor to check whether matter giving rise to such modification is

- Resolved by mgt. ↓ Clear report (If material, then may highlight in his AR)
- unresolved ↓ Modify regarding corresponding figure. ↓ whether affects C.Y. figures
  - **Yes** Modify regarding C.Y. figures also
  - **No** X

**Unqualified/clear**

But during audit procedures comes across a material misstatement, affecting prior years financial statement.

⇓

Audit or examine whether disclosed by mgt.

- Yes ↓ (Clear, may highlight in in his A.R.)
- No ↓ modify regarding corresponding figure.

⇒ If prior pd[s] f.st. not audited, state in AR that corresponding figures are un-audited.

## AAS-26

## TERMS OF AUDIT ENGAGEMENT

The auditor and the client should - agree on the terms of the engagement. The agreement should be in writing.

**Audit Engagement Letters:** The auditor should send an engagement letter, preferably before the commencement of the engagement, to help avoid any misunderstanding.

**Principal contents of audit** engagement letter

a. Objective of Audit of financial statements.

b. Management's responsibility for the financial statements.

c. Management's responsibility for selection and consistent application of accounting policies and accounting standards.

d. Management's responsibility for preparing the financial statements on a going concern basis.

e. Management's responsibility for making judgements and estimates that are reasonable and prudent.

f. Management's responsibility for the maintenance of adequate records and internal controls.

g. The scope of audit, including reference to applicable legislation, regulations, etc.

h. The fact that having regard to test nature of an audit, persuasive rather than conclusive nature of audit evidence together with inherent limitations of internal control system, there is an unavoidable risk that some fraud and error may remain undetected.

i. Unrestricted access to whatever records, documentation and other information requested in connection with audit.

**Additional matters in the engagement letter**

a. Planning of the audit

b. Written confirmation from management in connection with audit

c. Request for the client to confirm the terms of engagement by acknowledging the receipt of the engagement letter.

d. Any other reports or letters the auditor expects to issue.

e. Fees and billing arrangements.

f. Involvement of other auditors and experts

g. involvement of internal auditors and other staff of the client.

h. Arrangement with predecessor auditor.

i. Any restrictions of the auditors liability, where such possibility exists.

**Audit of Components (e.g. Subsidiary, Branch, Division, etc)**

When the auditor of parent company is also the auditor of its subsidiary, branch or division, he should consider certain factors like legal requirements, independence of management, degree of ownership by parent, extent of work performed by other auditors etc in deciding whether to issue separate engagement letters.

**Recurring Audits**

The auditor should consider whether the circumstances require the terms of the engagement to be revised and whether there is a need to remind the client of the existing terms of the engagement.

**Acceptance of a change in engagement**

- In case an auditor. is requested to change the engagement to one that provides a lower level of assurance before completion of the engagement, he should consider the appropriateness of doing so and should agree on the new terms.

- A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of service originally requested would ordinarily be considered a reasonable basis for requesting change in engagement.

- Before agreeing to change, the auditor should consider, any legal or contractual implications of the change.
- Where the terms of engagement are changed, the auditor and client would agree on new terms.
- The auditor would not agree to change of engagement if there is no reasonable justification for doing so.
- If the auditor is unable to agree to a change of the engagement and is not permitted to continue the original engagement, he should withdraw from the engagement and consider any obligation to report the circumstances necessitating the withdrawal to other parties, viz. Board of directors or shareholders.

# AAS-27

## COMMUNICATIONS OF AUDIT MATTERS WITH THOSE CHARGED WITH GOVERNANCE

**Governance:** The term “governance” is used to describe the role of persons entrusted with supervision, control and direction of an entity.

**Audit Matters of Governance interest:** Those matters that arise form the audit of financial statements and are in the opinion of the auditor, both important and relevant to those charged with governance in overseeing the financial reporting and disclosures process.

**Relevant Persons:**

a. The auditor should determine relevant persons who are charged with governance and with whom the audit matters of governance interest and to be communicated.

b. The auditor uses his judgment to determine the relevant persons.

c. He considers the governance structure of the entity the circumstances of engagement, relevant legislations, etc.

d. He also considers the importance and sensitivity of the audit matters.

e. Where it is not possible to identify the relevant persons, the auditor comes to an agreement with the entity with whom the audit matters of governance are to be communicated.

f. Communications of governance matters may be included in the audit engagement latter.

g. The engagement letter may include the form of communications and the relevant persons with whom such communications shall be made.

**Audit matters *of* governance interest to be communicated.**

a. The general approach and overall scope of audit

b. Any expected limitation or any additional requirements

c. The selection of or changes in, significant accounting policies and practices, that have or could have a material effect on the entity's financial statements.

d. Audit adjustments that could have a significant effect on the entity's financial statements or auditor's report.

e. Material uncertainties that may cast a doubt on the going concern assumption.

f. Disagreement with management that could be significant to entity's financial statement or auditors report.

g. Expected modifications to the auditor's report.

h. Material weakness in the internal control system.

i. Questions regarding management's integrity and fraud involving management.

**Timely communications:** The auditor should communicate the audit matters of governance interest on a timely basis. This enables those charged with governance to take appropriate action.

**Forms *of* communications:** The communications can be made orally or in writing. The form is affected by factors such as:-

a. The size, operating structure, legal structure and communications process of the entity.

b. The nature, sensitivity and significance of the audit matters to be communicated.

c. The arrangement made with respect" to periodic meetings or reporting of audit matters of governance interest.

**Oral Communications of audit matters:** In this case, the auditor should document in the working paper the matters communicated and any responses to those matters.

**Other matters:** Communications between the auditor and those charged with governance cannot be regarded as a substitute for such qualified, adverse or disclaimer of opinion.

**Confidentiality:** The requirements of professional pronouncements, legislations or regulations may impose obligations of confidentiality that restrict the auditor's communications of audit matters of governance interest. In such cases the auditor may wish to consult a legal counsel.

**Laws and regulations:** The requirements of professional pronouncements, legislations or regulations may impose obligations on the auditor to make communications on governance related matters. These additional communications requirements may affect the form, content and timing of communications with those charged with governance.

## AAS-28

## The Auditor's Report on Financial Statements

### Basic elements of an Auditor's Report

a. **Title:** It may be appropriate to use the term "Auditor" to distinguish the auditor's report from report issued by others.

b. **Addressee:** The auditor's report should be appropriately addressed as required by the circumstances of the engagement and applicable laws and regulations.

c. **Opening or Introductory paragraph:** The report should identify the financial statements that have been audited including the date and period covered by the financial statements. The report should include a statement of responsibility of the entity's management and of the auditor.

d. **Scope paragraph:** The report should describe the scope of the audit by stating that the audit was conducted in accordance with the auditing standards generally accepted in India. The report should include a statement that the audit provides a reasonable basis for opinion.

e. **Opinion paragraph:** The report should clearly indicate the financial reporting framework used to prepare the financial statements and express an opinion on the true and fair view in accordance with that financial reporting framework and where appropriate the compliance with the statutory and /*or* regulatory requirements.

f. **Date of the report:** The report should be dated as of the completion date of the audit, which should not be earlier than the date on which the financial statements are signed or approved by the management.

g. **Place of signature:** The report should name the specific location which is ordinarily the city where the audit report is signed.

h. **Auditor's signature:** The report should be signed in the name of the firm, the personal name of the both as appropriate.

### Auditor's Report

The auditor should incorporate in his report, the matters specified by a statute or regulator and/or report in the form prescribed by them in addition to the requirements prescribed above.

An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for preparation and presentation of the financial statements.

Under following situations auditor's report may have to be modified:

- Matters that do not affect the auditor's opinion.
- Matters that do affect the auditor's opinion including qualified opinion, disclaimer of opinion or adverse opinion.

In respect of matters that do not affect the auditor's opinion, the auditor should modify the report by adding a paragraph to highlight a matter for example some uncertainty regarding a going concern problem which is unresolved ,or a significant uncertainty the resolution of which is dependent on future events and which may significantly affect the financial statements and the same has already been incorporated by management in financial statement. In such matters, the opinion paragraph would refer to the fact that the auditor's opinion is not qualified in this respect.

Matters that do affect the auditor's opinion: The AAS specifies that in respect of matters that do affect the auditor's opinion

a. A 'qualified opinion' should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with the management is not so material and pervasive as to require a adverse opinion, or limitation on scope is not material and pervasive as to require a disclaimer of opinion.

b. A 'disclaimer' of opinion' should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor is unable to obtain sufficient appropriate audit evidence and is hence unable to express an opinion on the financial statements.
c. An 'adverse opinion' should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is inadequate to disclose the misleading or incomplete nature of the financial statements.

**Opinion other than an unqualified opinion:** Whenever the auditor requires an opinion other than unqualified, a description of all the substantive reasons should be included in the report and quantification of the possible effect(s), individually and in aggregate, on the financial statements should be mentioned in the report.

**Limitation on Scope:** The AAS also requires that in case there is a limitation on scope that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments that might have been necessary had the limitations not existed.

## AAS- 29

## INFORMATION SYSTEMS ENVIRONMENT

**Computer Information Systems (CIS):** CIS environment. is one where one or more computers of any type or size is involved in the processing of financial information of significance to the audit, where those computers are operated by the entity or by a third party.

**Factors to determine the effect of CIS' environment on the audit**

a. The extent to which CIS environment is used to record, compile and analyse accounting information.

b. The system of internal control in existence in the entity with regard to flow of complete and correct data to the processing centre and the processing, analysis and reporting tasks undertaken in the installation.

c. The impact of computer based accounting system on the audit trail that would otherwise exist in a manual system.

**Skills and competence needed in CIS environment:** The auditor should have sufficient knowledge of the CIS to plan, direct, supervise, control and review the work performed. He should consider whether any specialized skills are needed in the conduct of the audit.

If the use of professional possessing specialized skill is planned, the auditor should in accordance with AAS- 9 "Using the work of an expert" obtain sufficient, appropriate audit evidence that the work performed by the expert is adequate for the purpose of the audit.

**Planning an audit in CIS environment'**

a. The auditor should obtain an understanding of the accounting and internal control systems, sufficient to plan the audit and to determine the nature, timing and the extent of audit procedures.

b. In planning the portions of the audit, which may be affected by the environment, the auditor should obtain an understanding of the significance and complexity of the CIS activities and the availability of data for use in the. audit.

**Matters to be considered while planning**

a. The CIS infrastructure (hardware, operating systems) and application software used by the entity.

b. Significance and complexity of computerized processing in each significant accounting application.

c. Determination of the organizational structure of the client's CIS activities and extent of concentration or distribution of computer processing throughout the entity.

d. Determination of availability of data.

e. Potential for Computer Assisted Audit Techniques.

**Nature of risks and the internal control characteristics in CIS environments**

**(a)** ***Lack of transactions trails*** – Some CIS may provide complete transaction trail, however some may not provide it (OLRT). If there is absence of trail, the risk will be high (IR + CR).

**(b)** ***Uniform processing of transactions*** **–** Uniform processing of transaction can eliminate clerical errors which are there with manual processing. However, programming errors may occur.

**(c)** ***lack of segregation of functions*** **–** The extent of segregation of functions present in manual systems may not be there in CIS environment. Thus, an individual performing many computer related works may be in a position to perform incompatible function.

**(d)** ***Potential for errors and irregularities in the development, maintenance and execution of Computer Information System*** **–** The potential for human error in development, maintenance & execution of CIS may be greater than in manual system (due to technical incompetence).

**(e)** ***Initiation or execution of transaction automatically may not be authorized or documented*** **–** CIS may initiate certain transactions automatically. The authorization of these transactions may not be documented (for Ex. – ERP)

(f) ***Dependence of other controls over computer processing* –** Manual control procedure may also be used while implementing CIS.

(g) ***Potential for increased management supervision may serve to enhance the entire internal control structure* –** If management uses all the technologies & tools to review & supervise the CIS department of entity, the risk will be reduced.

(h) ***Potential for use of computer-assisted audit techniques* –** Due to peculiarities of some transaction and systems, auditor may be required to apply CAAT.

**Evaluating the reliability of the Accounting and Internal Control Systems** These systems should

a. Ensure that authorized, correct and complete data is made available for processing.
b. Provide for timely detection of errors.
c. Ensure that in case of interruption in the working of the CIS environment due to power, mechanical or processing failures, the system restarts without distorting the completion of entries or records.
d. Ensure the accuracy and completeness of the output.
e. Provide adequate data security against fire and other calamities, wrong processing, fraud, etc.
f. Prevent unauthorized amendments to the programs.
g. Provide for safe custody of the source code of the application software and the data files.

**Assessment of Risk:** Based on an understanding of the CIS environment, the auditor should make an assessment of inherent and control risks for material financial statements in accordance with AAS-6 "Risk Assessments and Internal Control".

**Audit Procedures:** The auditor should consider the CIS environment in designing audit procedures to reduce audit risk to an acceptably low level. He should ensure that adequate procedures exist to ensure that the data transmitted is correct and complete. .

**Documentation:**

a. He should document the audit plan, the nature, timing and the extent of audit procedures performed and the conclusions drawn from the evidence obtained.
b. In CIS environment, some of the audit trail may be in the electronic form. He should satisfy himself that such evidence is adequately and safely stored and is retrievable in its entirety as and when required.

# AAS-30

# EXTERNAL CONFIRMATIONS

1. **Objective:** To establish standards on the auditor's use of external confirmations as a means of obtaining audit evidence.

2. **External Confirmation** :- It is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by the management.

   The auditor should determine whether the use of external confirmations is necessary.

3. **Process of External Confirmations:**
   a. Selecting the items for which confirmations are needed.
   b. Designing the form of the confirmation request.
   c. Communicating the confirmation request to the appropriate third party.
   d. Obtaining response from third party.
   e. Evaluating the information or absence thereof.

4. **Situations where External Confirmations may be used:**
   a. Accounts balances and their components
   b. Terms of agreement or transactions with third parties.
   c. Bank Balance and other information from bankers.
   d. Stock held by third parties.
   e. Property title deeds held by third parties.
   f. Investments purchased but delivery not taken.
   g. Loans from lenders
   h. Long outstanding share application money.

5. **Reliability of evidence obtained by External Confirmations:**

It depends on -
   a. The application of appropriate procedures by the auditor in designing the external confirmation.
   b. Performing external confirmation procedure and evaluating the request of the external confirmation procedures.
   c. The control which the auditor exercises over confirmation request and responses.
   d. The characteristics of respondents
   e. Any restrictions included in the response or imposed by management.

6. **Relationship of, External Confirmation Procedures to the Auditor's Assessment of Inherent Risk and Control Risk.**
   The auditor should assess whether the evidence provided by the confirmations reduces audit risks for the related assertions to an acceptably low level. If the auditor is satisfied that the evidence provided by the confirmations alone is not sufficient, he should perform additional procedures.

7. **Assertions Addressed by External Confirmations -** The ability of an external confirmation to provide evidence relevant to a particular financial statement assertion varies.

   The external confirmation of an account receivable provides strong evidence regarding' the existence of the account as at a certain date. Confirmations also provides evidence regarding the operation of cut-off procedures. However, such confirmation does not provide all the necessary audit evidence relating to the assertion regarding valuation.

   When obtaining evidence for assertions not adequately addressed by confirmations, the auditor considers other audit procedures to complement confirmation procedures or to be used instead of confirmation procedures.

8. **Timing of External Confirmations -** External confirmation may be requested either at the date of financial statements or as at any other selected dates close to the date of financial statements. The date may be settled in consultation with the management. When the level of inherent and control risk is high, the auditor may decide to confirm balances at a date other than the period end.

9. **Design of the External Confirmation Request–**The auditor should design external confirmation requests to the specific audit objective.

10. **Nature of Information being confirmed -** In designing the request, the auditor consider the type of information respondents will be able to confirm readily since this may affect the response rate and the nature of evidence obtained. Respondents will be more willing to a confirmation request containing management authorisation.

11. **Prior Experience -** The auditor should consider the information from audits of earlier years while designing external confirmation requests.

12. **Form of confirmation request–** Use of Positive and Negative Confirmations:

***Positive confirmation request* -** It asks the respondent to reply to the auditor in all cases either by indicating the respondent's agreement with the given information, or by asking the respondent to fill in information.

***Negative confirmation request* -** It asks the respondent to reply only. in the event of disagreement with the information provided in the request. Negative confirmation request should be used when:

a. the assessed level of inherent and control risk is low;
b. a large number of small balances is involved;
c. a substantial number of errors is not expected; and
d. the auditor has no reasons to believe that respondents will disregard these requests.

A combination of positive and negative combinations may be used.

13. **Characteristics of Respondents**

The reliability of evidence is affected by the respondent's competence, independence, authority to respond, knowledge of the matter being confirmed, and objectivity. Therefore, the confirmation request should be directed to appropriate individual.

The auditor also assesses whether certain parties may not provide an objective or unbiased .response to a confirmation request. The auditor considers the effect of such information on designing the confirmation request and evaluating the results, including determining whether additional procedures are necessary.

14. **The external confirmation process -**

- The auditor should maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of confirmation requests, and the responses to those requests.
- He should ensure that it is he (the auditor) who sends out the confirmation requests, the requests are properly addressed, and that it is requested that all replies and the undelivered confirmations are delivered directly to the audit.
- He should perform alternative procedures when no response is received to a positive external confirmation requests.
- The auditor should consider whether there is any indication that external confirmations received may not be reliable.
- The auditor should also consider the authenticity of the response and perform appropriate procedures to dispel any doubts. Oral confirmations should be documented in work papers.
- If the confirmation process and alternative procedures have not provided sufficient appropriate audit evidence regarding an assertion, the auditor should undertake additional procedures to

obtain sufficient appropriate audit evidence.

- Any discrepancy revealed by the external confirmations received or by additional procedures carried out by the auditor might have a bearing on the assertions and the accounts within the given assertion not selected for external confirmation. The auditor in such a case, should request the management to verify and reconcile the discrepancies.

- He should also consider the causes and frequency of exceptions reported by respondents. If the responses received indicate a pattern of misstatements, the auditor should reconsider his assessment of inherent and control risk and also consider the effect on his audit procedures.

**Management Requests**

When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should consider whether there are valid grounds for such a request and obtain evidence to support the validity of management's requests. The auditor should also seek the management to submit its request in a written form, detailing therein the reasons for such request.

If the auditor agrees to managements requests not to seek external confirmation regarding a particular matter, the auditor should –

a. document the reasons for acceding to the management's request; and

b. apply alternative procedures to obtain sufficient appropriate evidence.

If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor's work and the auditor should consider the possible impact on the auditor's report. The auditor should, however. in this case also, document the request made by the management along with the reasons given by the management as well as his own reasons for acceding to the management's request.

# AAS – 31
# ENGAGEMENTS TO COMPILE FINANCIAL INFORMATION

1. **OBJECTIVE –** To establish standards on professional responsibilities of an accountant when an engagement to compile financial statements or other financial information is undertaken and form and content of the report to issued in connection with such a compilation so that the association of name of the accountant with such financials is not misconstrued by a user of those statements or information as having been audited by him.

2. **OBJECTIVES OF A COMPILATION ENGAGEMENT –** The objective of a compilation engagement is an accountant to use accounting expertise, as opposed to auditing expertise, to collect, classify summarize financial information. This requires reducing detailed data to manageable and understandable form without the requirement to test the assertions underlying that information.

3. **GENERAL PRINCIPLES OF A COMPILATION ENGAGEMENT –** The accountant should comply with the "Core of Ethic" issued by ICAI. The ethical principles are –
   (a) Integrity;
   (b) Objectivity;
   (c) Professional Competence and due care;
   (d) Confidentiality;
   (e) Professional conduct; and
   (f) Technical Standards

   If the accountant is not independent, a statement to that fact should be made in the accountant's report. When an accountant's name is associated with financial information compiled by him, the accountant should issue a report.

4. **RESPONSIBILITY OF MANAGEMENT –** It includes –
   (a) Ensuring that the financial information generated in the entity is correct, complete and reliable.
   (b) Maintaining adequate accounting and other records and internal controls.
   (c) Selecting and applying appropriate accounting policies.
   (d) Establishing controls designed to safeguard the assets of the entity.
   (e) To deter fraudulent or other dishonest conduct and to detect any fraud that occurs.
   (f) Assuring that the entity complies with laws and regulation applicable to its activities.

   A compilation engagement carried out by the accountant does not relieve the management of these responsibilities. The accountant should obtain an acknowledgement from the management of its responsibility for the appropriate preparation and presentation of financial statements or other information.

5. **DEFINING THE TERMS OF THE ENGAGEMENT –** The accountant should ensure that there is a clear understanding the terms of the engagement by means of an engagement letter helps avoid misunderstanding regarding matters such as the objective and scope of the engagement and the extent of the auditor's responsibilities. The engagement letter would include –
   (a) Nature of the engagement
   (b) Fact that the engagement can't be relied upon the disclose frauds or defalcations
   (c) Nature of the information to be supplied by the client.
   (d) Fact that the management is responsible for –
      i. Accuracy and completeness of the information supplied including maintenance of adequate accounting records and internal control.
      ii. Preparation and presentation of financial statements in accordance with applicable laws.

iii. Safeguarding the assets of the entity and preventing and detecting fraud and other irregulations.
iv. Ensuring that activities of the entity are carried in accordance with applicable laws and regulations.
v. Ensuring complete disclose of all material and relevant information to the accountant.

(e) Intended use and distribution of the information, once compiled.
(f) Basic of accounting on which financial information is to be compiled.
(g) The fact that the management is responsible to the users for the information to be compiled by the accountant.
(h) Basis on which fees would be computed and any billing arrangements.
(i) Request for the client to confirm the forms of engagement by acknowledging the receipt of the engagement letter.

6. **PLANNING AND DOCUMENTATION –** The accountant should plan the work so that an effective engagement will be performed. He should document matters which care important in providing evidence that the engagement was carried out in accordance with this Auditing and Assurance Standard and the terms of the engagement.

7. **PROCEDURES –**
(a) The accountant should obtain a general knowledge of the business and operation of the entity and should be familiar with the accounting and practice of the industry in which the entity operates.
(b) He should be familiar with the form and the content of financial statements / other financial information which is appropriate in the circumstances.
(c) He should request management representation letter covering significant information or explanations given orally on which he considers representations are required.
(d) If he becomes aware that the information supplied by management is incorrect, incomplete or unsatisfactory, he should consider performing additional procedures, e.g. making inquiries, assessing internal controls, etc. If the management refuses to provide additional information, he should withdraw from the engagement.
(e) He should read the compiled information and consider whether it appears to be appropriate in form and free from obvious material misstatements.

8. **SPECIAL CONSIDERAIONS –**
(a) Clients having an Identified Reporting Framework – in this case, the accountant should ensure that the financial statements or other financial information compiled comply with the requirements of the identified financial reporting framework. If case o any material departure, the fact should be stated in the notes to the Accounts or other compiled financial information as well as in the accountant's report.

(b) Clients having not Identified Financial Reporting Framework – since accounts are normally assumed to be compliant with the generally accepted accounting practices, including the accounting standards issued by ICAI, the different basis of compilation should be set out in the Notes to the Accounts or other compiled financial information as well as the report issued by the accountant on compilation

(c) Non-Compliance with the Accounting Standards – if the accountant becomes aware of material non-compliance with the relevant Accounting Standards, the same should be brought to the attention of the management. If the same is not rectified by the management, it should be included in the notes to the accounts and the compilation report of the accountant.

(d) Accounting Estimates made by Clients - if it appears that certain estimates made by the client are unreasonable, the accountant should draw these to the attention of the management for consideration.

9. **REPORTING ON COMPILATION ENGAGEMENT –** The financial statement or other financial information compiled should be approved by the client before the compilation report is signed by the accountant. It is essential that the accountant clearly brings out the nature of work with

the financial statements and the nature of work performed by him. The report on compilation should be in following lay out –

(a) Title – The title should be "Accountant's Report on compilation of unaudited Financial Statements" (and not "Auditor's Report").

(b) Address – The report should be addressed to the appointing authority.

(c) Identification of the financial information.

(d) When relevant, a statement that the accountant is not independent of the entity.

(e) A statement that management is responsible for –

    (i) Completeness and accuracy of the underlying data and complete disclosure of all material and relevant information.

    (ii) Maintaining adequate accounting and other records and internal control.

    (iii) Selecting and applying appropriate accounting policies.

    (iv) Preparation of financial statements and other information in accordance with applicable laws and regulations, if any.

    (v) Establishing controls to safeguard the assets of the entity and preventing and detecting fraud or other irregularities.

    (vi) Establishing controls for ensuring that activities of the enterprise and carried out in accordance with applicable laws and regulations.

(f) A statement that the engagement was performed in accordance with his Auditing and Assurance Standard.

(g) A statement that neither an audit nor a review has been carried out and that according no assurance is expressed on the financial information

(h) Date of report

(i) Place of signature, and

(j) Accountant's signature – the report should be signed by the accountant in his personal name. Where a firm is appointed, the report should be signed in the personal name of the accountant and in the name of the firm. The membership number assigned by ICAI should be mentioned.

## AAS – 32

## ENGAGEMENTS TO PERFORM AGREED UPON PROCEDURES REGARDING FINANCIAL INFORMATION

1. **INTRODUCTION –** In an engagement to perform agreed upon procedures, the auditor is engaged by the client issue a report of factual findings, based on specified subject matter of specified elements, accounts or items of a financial statement. For example, an engagement to perform agreed upon procedures may require auditor to perform certain procedures concerning, say, accounts payable, accounts receivable, purchases from related parties, etc.
   This AAS may also provide useful guidance for engagement to perform agreed upon procedures regarding non-financial information, provided he has adequate knowledge of the subject matter and reasonable criteria exist on which to base his findings.

2. **OBJECTIVE –** To establish standard and provide guidance3 on the auditor's professional responsibilities when an agreed upon procedures regarding financial information is undertaken and on the form and content of the report that the auditor issues in connection with such an engagement.

3. **OBJECTIVE OF AN AGREED UPON PROCEDURES ENGAGEMENT –** The objective on an engagement is for the auditor to carry upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.

   The auditor simply provides a report of the factual findings of agreed upon procedures, no assurance is expressed by him in his report. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the result.

4. **GENERAL PRINCIPLES OF AN AGREED UPON PROCEDURES ENGAGEMENT –** The auditor should comply with the Code of Ethics, issued by ICAI. The ethical principles are –
   (a) Integrity
   (b) Objectivity;
   (c) Professional competence and the care;
   (d) Confidentiality
   (e) Professional conduct; and
   (f) Technical Standards.

   When the auditor is not independent, a statement to that effect should be made in the report of factual findings.

   The auditor should conduct an agreed upon procedure engagement in accordance with this AAS and the terms of the engagement.

5. **DEFINING THE TERMS OF THE ENGAGEMENT –** There should be a clear understanding among the auditor, the client and other specified parties, who will receive copies of the report of factual findings regarding the agreed procedures and the conditions of the engagement. The nature to be agreed include the following:
   (a) Nature of the engagement
   (b) Stated purpose for the engagement

(c) Identification of the financial information to which he agreed upon procedures will be applied.
(d) Nature, timing and extent of the specific procedures to be applied.
(e) Limitations on distribution of the report of factual findings. When such limitation would be in conflict with legal requirements, the auditor, would not accept the engagement.

The auditor should send an engagement letter documenting the key terms of the appointment. An engagement letter helps avoid misunderstanding regarding such matters as the objectives and scope of engagement, the extend of auditor's responsibilities and the form of report to be issued.

6. **PLANNING AND DOCUMENTATION –** The auditor should plant the work so that an effective engagement will be performed in providing evidence to support the report of factual findings, and evidence that the engagement was carried out in accordance with this AAS and the term of the engagement.

7. **PROCEDURES AND EVIDENCE –** The auditor carry out the procedures agreed upon and use the evidence obtained as the basis for the report of factual findings. The procedures may includes –

(a) Inquiry and analysis.
(b) Recompilation, comparison and other clerical accuracy checks.
(c) Observation
(d) Inspection
(e) Obtaining confirmations.

8. **REPORTING –** The report needs to describe the purpose and agree upon procedures in details to extent of work performed. The report should also clearly mention that no audit ore review work has been performed. The report should certain –

(a) Title
(b) Addressee (ordinarily the appointing authority);
(c) Identification of specific financial or non-financial information
(d) A statement that the procedure performed were those agreed upon with the recipient;
(e) A statement that the engagement was performed in accordance with this AAS.
(f) Identification of the purpose for which the agreed upon procedures were performed;
(g) A listing of the specific procedures performed.
(h) A description of the auditor's factual findings.
(i) A statement that procedures performed do not constitute either an audit or a review, and, as such, no assurance in expressed.
(j) A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported;
(k) A statement that the report is restricted to those parties that have agreed to the procedures to be performed.
(l) A statement (when applicable) that the report relates only to the elements, accounts, items or financial or non-financial information specified and that it does not extent to the entity's financial statement taken as a whole;
(m) Date of the report;
(n) Place of signature;
(o) Auditor signature – The report should be signed by the auditor in his personal name. When a firm is appointed the report signed in the personal name of the auditor and the firm. The membership number assigned by ICAI should also be mentioned.

## AAS 33
## Engagements to Review Financial Statements

### General Principles of a Review Engagement

1. The auditor should comply with the Code of Ethics issued by the Institute of Chartered Accountant of India.
2. The auditor should conduct a review in accordance with the AAS.
3. For the purpose of expressing negative assurance in the review report, the auditor should obtain sufficient appropriate evidence primarily through inquiry and analytical procedures to be able to draw conclusions.

### Scope of a Review

The procedures required to conduct a review of financial statements should be determined by the auditor having regard to the requirements of this AAS, relevant legislation, regulation and, where appropriate, the terms of the review engagement and reporting requirements.

### Terms of Engagement

The auditor and the client should agree on the terms of the engagement.

### Planning

1. The auditor should plan the work so that an effective engagement will be performed.
2. In planning a review of financial statements, the auditor should obtain or update the knowledge of the business including consideration of the entity's organization, accounting systems, operating characteristics and the nature of its assets, liabilities, revenues and expenses.

### Work Performed by Others

When using work performed by another auditor or an expert, the auditor should be satisfied that such work is adequate for the purposes of the review.

### Documentation

The auditor should document matters which are important in providing evidence to support to review, and evidence that the review was carried out in accordance with this AAS.

### Procedures and Evidence

1. The auditor should apply judgment in determining the specific nature, timing and extend of review procedures.
2. The auditor should apply the same materiality considerations as would be applied if an audit opinion on the financial statements were being given.
3. The auditor should inquire about events subsequent to the date of the financial statements that may require adjustment of or disclosure in the financial statements.
4. If the auditor has reason to believe that the information subject to review may be materially mis-stated, the auditor should carry out additional or more extensive procedures as are necessary to be able to express negative assurance or to confirm that a modified report is required.

### Conclusion and Reporting

1. The review report should contain a clear written expression of negative assurance. The auditor should review and assess the conclusions drawn from the evidence obtained as the basis for the expression of negative assurance.

2. Based on the work performed, the auditor should assess whether any information obtained during the review indicates that the financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects,') in accordance the framework used for the preparation and presentation of financial statements and relevant statutory requirements, if any.

3. The report on a review of financial statements should contain the following basic elements, ordinarily in the following layout:

   (a) Title[5];

   (b) Addressee;

   (c) Opening or introductory paragraph including;

      (i) Identification of the financial statements on which the review has been performed; and

      (ii) A statement of the responsibility of the entity's management and the responsibility of the auditor;

   (d) Scope paragraph, describing the nature of a review, including:

      (i) A reference to this AAS applicable to review engagements, or to relevant laws or regulations;

      (ii) A statement that an audit has not been performed, that the procedures undertaken provide less assurance than an audit and that an audit opinion is not expressed;

   (e) Statement of negative assurance;

   (f) Date of the report;

   (g) Place of Signature; and

   (h) Auditor's signature and membership number assigned by the Institute of Chartered Accountants of India.

4. The review report should:

   (a) State that nothing has come to the auditor's attention based on the review that causes the auditor to believe the financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects') in accordance with the framework used for the preparation and presentation of financial statements (negative assurance)[6]; or

   (b) If matters have come to the auditor's attention, describe those matters that impair a true and fair view (or a fair presentation, in all material respects) in accordance with the framework used for the preparation and presentation of financial statements including, unless impracticable, a quantification of the possible effect(s) on the financial statements, and either:

      (i) Express a qualification of the negative assurance provided; or

      (ii) When the effect of the matter is so material and pervasive to the financial statements that the auditor concludes that a qualification is no adequate to disclose the misleading or incomplete nature of the financial statements, give an adverse statement that the financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects') in accordance with the framework used for the preparation and presentation of financial statements; or

   (c) If there has been a material scope limitation, describe the limitation and either:

      (i) Express a qualification of the negative assurance provided regarding the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed; or

      (ii) When the possible effect of the limitation is so significant and pervasive that the auditor concludes that no level of assurance can be provided, not provide any assurance.

5. The auditor should date the review report as the date the review is completed, which includes performing procedures relating to events occurring up to the date of the report. However, since

the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the review report earlier than the date on which the financial statements were approved by management.

## AAS 34
## Audit Evidence-Additional Considerations for Specific Items

**PART A : ATTENDANCE AT PHYSICAL INVENTORY COUNTING**

The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence during his attendance at physical inventory counting.

**Definitions**

1. Physical verification of inventories is the responsibility of the management of the entity.
2. When inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting unless impracticable, due to factors such as the nature and location of the inventory.
3. If unable to attend the physical inventory count on the date planed due to unforeseen circumstances, the auditor should take or observe some physical counts on an alternative date and where necessary, perform alternative audit procedures to assess whether the changes in inventory between the date of physical count and the period end date are correctly recorded.
4. Where attendance at the physical inventory counting is impracticable, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition of inventory to conclude that the auditor need not make reference to a scope limitation.

**Management Representations**

The auditor should obtain a written representation from management concerning:

**(a)** The completeness of information provided regarding the inventory; and

**(b)** Assurance with regard to adherence to laid down procedures for physical inventory count.

**Audit Conclusions and Reporting**

If the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence of inventory or adequacy of procedures adopted by the management in respect of physical inventory count or concludes that the disclosure of inventory in the financial statements is inappropriate, he should consider its effect in his audit report.

**PART B : INQUIRY REGARDING LITIGATION AND CLAIMS**

**Definitions**

1. The auditor should carry out audit procedures in order to become aware of any litigation and claims involving the entity which may have a material effect on the financial statements.
2. When litigation or claims have been identified by the management or when the auditor believes hey may exist, and are likely to be material, the auditor should seek direct communication with the entity's lawyer.
3. The letter, which should be prepared by management and sent by the auditor, should request the entity's lawyer to communicate directly with the auditor.

4. If management refuses to give the auditor permission to communicate with the entity's lawyers, this would be a scope limitation and should ordinarily lead to a qualified opinion or a disclaimer of opinion.

**Management Representations**

The auditor should obtain a written representation from management concerning:

**(a)** The completeness of information provided regarding the identification of litigation and claims; and

**(b)** The adequacy of litigations and claims disclosures in the financial statements.

**PART C : VALUATION AND DISCLOSURE OF LONG TERM INVESTMENTS**

The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence for valuation and disclosure of long term investments.

**Definitions**

When long-term investments are material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding their valuation and disclosure.

**Management Representations**

The auditor should obtain a written representation from management concerning:

**(a)** The completeness of information provided regarding valuation and disclosure off long term investments.

**(b)** The valuation of long term investments in the financial statements including adequacy of provision for diminution in such values, wherever required.

**Audit Conclusions and Reporting**

If the auditor is unable to obtain sufficient appropriate audit evidence concerning the existence, valuation of long term investments or concludes that their disclosure in the financial statements is not adequate, he should consider its effect in his audit report.

**PART D: SEGMENT INFORMATION**

The auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence for appropriate disclosure of segment information.

**Definitions**

When segment information is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its disclosure in accordance with the applicable identified financial reporting framework.

**Management Representations**

The auditor should obtain a written representation from management concerning:

**(a)** The completeness of information regarding segments and disclosure thereof; and

**(b)** Appropriateness of the selected segments based on risks and returns; and

**(c)** The organizational structure of an enterprise and its internal financial reporting system and deviation therefrom.

**Audit Conclusions and Reporting**

If the auditor is unable to obtain sufficient appropriate audit evidence concerning segment information or concludes that their disclosure in the financial statements is not adequate, he should consider its effect in his audit report.

**Effective Date**

This Auditing and Assurance Standard becomes operative for all audits related to accounting periods beginning on or after 1st April, 2005.

# Guidance Note on Revision of Audit Report

⇒ Revision of Audit Report after the same has been issued, in case auditor considers necessary to do so.

⇒ If Auditor becomes aware subsequent to his audit report that facts may have existed at that date which might have affected his report had he been aware of such facts at time of issuance of A.R.

⇒ It doesn't apply to developments after date of A.R. or where contingencies already disclosed in financial statement.

⇒ For e.g. – Apparent mistake, wrong information about facts, subsequent discovery of facts, etc.

⇒ Revision of A.R. doesn't free the member from professional misconduct, committed by him.

⇒ Auditor may advise the management to amend financial statement before issuing the A.R.

⇒ Auditor may issue the revised report referring therein earlier report if management ensures that everyone in receipt of previously issued financial statement alongwith A.R. is informed of the situation.

⇒ However, for company's revise report till A/c. at adopted at AGM. For others, revise within reasonable time but not later than issuance of A.R. for immediately next A/c. period.

⇒ If management doesn't ensure auditor, he may seek legal advice, notify the client that A.R. no longer be associated with financial statement, notify Regulatory Agencies and make app. Statement at AGM.

⇒ If management doesn't ensure the same auditor may conclude to withdraw from further engagement.

⇒ Auditor being partnership firm, same partner should sign revised report. If not, give reasons.

⇒ Revised report should be self contained.

## Guidance Note on Auditor's Report on Revised Accounts of Companies, before circulation to shareholders

⇒ When amended accounts are re-approved by the boards of the Company and Statutory Auditors are requested to make a report once again on the amended accounts.

⇒ Auditor to ensure that all copies of original accounts and report are returned to him and adequate disclosure of the fact of revision appears as a specific note on the amended accounts.

⇒ However, if notes to amended accounts don't contain any note on revision or if such a note is not considered by statutory auditor as adequate, it will be his duty to refer to the fact of revision of accounts, in his report.

⇒ Council decided that re-opening or rectification of Accounts after they have been adopted at the AGM *shouldn't* be permitted any circumstances.

# Special Aspects

## Non-Banking

**Classification of NBFC :**

**A.** NBFC is one whose principal business is that of receiving deposits or that of financial institution.

1. Equipment Leasing Company.
2. Hire Purchase Finance Company.
3. Investment Company.
4. Loan Company.
5. RNBC *i.e.* Residuary non-banking co. that receives deposits under any scheme.

**B. MBFC (Mutual benefit Financial Co.) :** *i.e.* Nidhi Co. notified by Central Government u/s 620 A of Companies Act.

**C. MBC (Mutual Benefit Company) :** *i.e.* potential Nidhi co. working on lines of Nidhi co. but not so notified by Sec. 620A of Companies Act and Central Government. Company having minimum net owned fund and preference share capital of 10 lacs.

**D. MNBC (Miscellaneous Non-banking co.) :** *i.e.* Chit Fund company. Where a company enters into an agreement with specified number of subscribers to subscribe a certain sum and everyone of them be entitled to a prize amount. (may be by lot).

### AUDIT PROCEDURE

1. Ascertaining the business of the Company.
2. Evaluation of I.C. System.
3. Registration with RBI which is compulsory for companies having net owned funds 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.
4. *NBFC Public Deposit Directions*
   - (i) Public deposit in accordance with the credit rating assigned to it.
   - (ii) Interest calculations.
   - (iii) NBFC accepted public deposit or renewed it only after written application received by the depositor in a specified form.
   - (iv) Public deposits should be accepted only after advertisement or statement in lieu of advertisement has been filed with RBI.
   - (v) Check deposit register (payment on due date).
   - (vi) Investment in approved liquid assets and it should be kept in safe custody.
   - (vii) Audited statement submitted within 15 days of Holding AGM to RBI.
   - (viii) Annual Return within 6 months from close of year submitted to RBI.
   - (ix) If not accepting deposits, see Board resolution in this behalf.
   - (x) For Group holding investment company, see board resolution to identify the group.
5. *NBFC Prudential Norms Directions*
   - (i) Compliance with income recognition and Accounting Standards, *etc.*
   - (ii) Classification as Standard / Sub-standard / Doubtful / Loss Asset.
   - (iii) Income from NPA on realization basis.
   - (iv) Previous year's NPA A/c. continue or not.

## CHECK-LIST FOR NBFC

**1. Equipment Leasing Finance Company:**

(i) Check whether proposals for equipment Leasing are accepted only after proper credit appraisal.

(ii) The auditor should verify the adequacy of system in place for ensuring installation of assets and their periodical physical verification.

(iii) The auditor should check the system to monitor whether Asset is adequately insured and properly maintained should be in place.

(iv) Verify the lease agreement.

(v) The auditor should ensure that leasing transactions are classified and accounted as per AS-19 “Lease”.

(vi) Ensure that the provisions relating to asset classification, provisioning and income recognition laid down for lease financing by NBFCs are observed.

**2. Hire Purchase Finance Company**

i. The auditor should ascertain whether there is an adequate appraisal system for extending hire-purchase finance.

ii. The auditor should verify that payments for assets are made directly to the vendor and the assets are property charged in the name of the NBFC.

iii. The auditor should ascertain the adequacy of system in place to ensure installation of the asset and their periodic physical verification.

iv. If the finance is against vehicles, the registration certificate should contain an endorsement in favour of the NBFC.

v. Auditor should verify the system to ensure that hirer have not sold the assets or encumbered them.

vi. Whether hire-purchase instalments are received regularly.

vii. The auditor should verify that hire purchase assets are adequately insured.

viii. Check the valuation of goods sold on hire purchase and goods repossessed.

ix. Examine the method of accounting followed for appropriation of finance charges over the period of hire purchase contract.

**3. Investment Company**

(i) The Auditor should physically verify the investment certificate. If these are lodged with another institute/bank obtain a certificate to that effect.

(ii) Verify whether investments made by the NBFC are within limits.

$$\text{Lend}\ \left[\begin{array}{l}\le 15\% \text{ of net owned funds to single borrower}\\ \le 25\% \text{ of net owned fund to single group of borrowers}\end{array}\right.$$

Same is the case with investment.

$$\text{Lending + investments}\ \left[\begin{array}{l}\le 25\% \text{ of net owned funds to single borrower}\\ \le 40\% \text{ of net owned fund to single group of borrowers}\end{array}\right.$$

(iii) Verify that no loans have been advanced on the security of its own share.

(iv) Verify whether income in the form of interest, dividend and capital gains is properly recognized.

(v) Test Check the bills/contract notes received from brokers *w.r.t.* prices in the stock market on the respective dates.

(vi) Verify the board minutes for authorization of purchase and sale of investments.

(vii) Shares/Securities held through depository, obtain confirmation from D.P.

(viii) Check whether investments have been valued as per NBFC Prudential Norms and AS 13 “Accounting for Investments”.

(ix) Obtain a list of subsidiary/group company from NBFC.

(x) Check the investments made in subsidiary / group companies for basis for price paid, quantum of investment made etc.

(xi) Ascertain that investments in unquoted debentures and bonds have not been classified as investments but as term loans for the purpose of asst classification, provisioning and income recognition.

(xii) Incase of securities lent / borrowed under securities lending scheme of SEBI, verify the terms and conditions of the agreement.

**4. Loan Company**

i. Ascertain whether there is system in place for proper appraisal, and sanction of loans.

ii. Verify the terms & conditions of loan agreement and security obtained.

iii. Check whether adequate records are maintained as regards the bill discounting facilities.

iv. Check whether the loans are within the limits specified for single and group borrowers.

v. No loans should be given of the security of NBFCs own shares.

vi. Check whether norms for asset classification, provisioning and income recognition as specified for credit facilities have been adhered to.

vii. The auditor may also obtain balance confirmation from the borrowers.

viii. Check whether there is adequate system to ascertain creditworthiness of client for co. engaged in business of providing short term fund in ICD market.

## AUDIT OF BANK BORROWERS

⇒ For those Non-corporate Borrowers enjoying working Capital Limits of Rs.25 lacs and above from the Banking System.

⇒ Term Borrowing includes (for purpose of limit) :

(i) Packing Credit facility.

(ii) Cash Credit facility

(iii) Loans – Secured and Unsecured.

(iv) O/D.

(v) Deferred Payment facility.

(vi) Guarantee (a) Performance, (b0 financial.

(vii) Bill Discounting facility.

(viii) Any other Credit facility.

⇒ To submit such audited statement and report to concerned bank, at earliest but not later than *6 months* from the close of Accounting year.

### ⇒ AUDIT PROCEDURES

(i) Auditor to use his professional skills and experience and apply such audit tests as required by circumstances. Report is special purpose report as it is to be given to lending bank.

(ii) Consider materiality. Perform compliance procedures.

(iii) Obtain all relevant informat and explanation from the client being audited.

(iv) Entity may choose any Chartered Accountant.

(v) Auditor to obtain letter of engagement and list of books of A/c. / records maintained by the entity before undertaking audit assignment.

(vi) Check compliance with terms of documents etc. (Partnership/Trust Deed) so far as they relate to A/c. and audit.

(vii) Figures of immediately preceding year for comparisons

(viii) (AAS-22 & 25).

(ix) Any material departure of A/c. from accepted principles / Policy followed in preceding year should be reflected in notes to A/c. / Auditor's report.

(x) Overall consideration whether financial statement give a true and fair view. It should help the lending banker in evaluation of loan proposals and strict financial discipline.

**Special Auditor Report :**

⇒ can be called by a lending bank, if circumstances wants. Submitted on *quarterly basis,* it is in addition to normal audit report which is on annual basis).

*Information regarding :*

(i) Actual Production.
(ii) Actual production as % of rated capacity.
(iii) Sales.
(iv) Cash of goods sold / cost of production.
(v) Gross margin.
(vi) Interest on bank borrowing.
(vii) Interest on others.
(viii) Age-wise classification of raw material and finished goods.
(ix) Basis of valuation of raw material and finished goods.
(x) Age wise classification of B/R and other receivables due from domestic parties and for exports.
(xi) Some ratio etc. also be given.
(xii) Information w.r.t. following
   (a) Balances at the end of each month of the quarter for major categories of stock, receivables and bills receivables;
   (b) Tax assessments and payments made during the quarter.
   (c) Actual disbursement of capital expenditure during the quarter;
   (d) Outstanding contracts.
   (e) The contingent liability;
   (f) Investment made during the quarter and the income from such investments including profit on sale of investments.
   (g) Loans given during the quarter;
   (h) Loans raised during the quarter
   (i) Overdue statutory liability at the end of the quarter;
   (j) 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
   (k) Figures of cash losses during the last 2 years to be stated on the basis of the annual accounts. If such accounts were not audited this fact should be stated.

## AUDIT OF CO-OPERATIVE SOCIETIES

⇒ Auditor’s objective to see how far the decisions are in line with co-operative principles. Interest of members, provision in respective law of state and provision of bye-laws of society.

⇒ Managing Committee of society does the following :
(i) Custody and maintenance of moveable/un-moveable property.
(ii) Maintenance of account for receipt/payment.
(iii) Summon and attend all meetings.
(iv) Keeping all registers and records required by Act.

**Auditor :**

⇒ C.A. or diploma holder or having served as auditor in co-operative department of Government.

⇒ Appointment by Registrar and report submitted to him and to society also.

⇒ Audit fee may be w.r.t., working capital at prescribed rates.

⇒ Books of accounts required for :
(i) Sum of money received and expanded.
(ii) All sales and purchases and accounts of st. in hand.
(iii) Assets and liabilities.

Further different books can also be maintained by the society.

⇒ For limited lia. Society, no member other than a registered society can hold share-holding exceeding 20% of shares or Rs.1,000.

⇒ No loan to any person other than member. Special permission to grant loan to another society.

⇒ Accept loan/deposits from members/others subject to bye-laws.

⇒ Investment in :
(i) Central/State Co-operative Bank.
(ii) Approved securities.
(iii) Share security bond, etc. of any other society with limited liability.
(iv) Any co-operative bank if approved by Registrar.
(v) Other money permitted by Central/State Government.

⇒ 25% of pt. Transferred to Reserve Fund before distribution to members. Registrar may reduce it but at least 10% is even then required. It may use Reserve fund in Business of a society or may invest or for some public purpose.

⇒ Some State Act provide for compulsory contribution to education fund of state.

⇒ Over due debts for 6 m – 5 yr. and more than 5 years classified and reported upon.

⇒ Overdue interest excluded from interest outstanding in calculation of pt.

⇒ Some Act provide that Bad debts can be written off only if certified as Bad.

⇒ Auditor to see *existence, ownership and valuation* of asset.

⇒ Special report to registrar for *e.g.* :
(i) Personal profiteering by members.
(ii) Detection of fraud.
(iii) Mis-management.
(iv) Urban co-operative bank, disproportionate advances to vested interest groups.
(v) Reckless advancing

⇒ Then he provides a *class* to society. If society is unsatisfied, it may appeal to Registrar and he may direct to review the audit classification.

⇒ **Audit Report :**

(i) All necessary information and explanation.
(ii) A/c. give all information required by Act.
(iii) P & L true and fair view.
(iv) B/S true and fair view of state of affairs.
(v) Proper Books of Accounts maintained.
(vi) P&L and B/S in agreement with Books of Accounts.

***Schedules to the report for :***
(i) Transaction contrary to Act, rules and Bye-laws
(ii) Sums not brought into A/c.
(iii) Material/property appearing as doubtful/bad.
(iv) Material irregularity in expenses/realization of money.
(v) Any other matter specified by registrar.

⇒ He may also have to answer two sets of questionnaire called audit memos.
(i) General nature (Applicable to all)
(ii) Practical nature (like for Housing agriculture, etc.)

# Multi State Co-operative Societies Act, 2002

❖ **Books of A/c: w.r.t :**
(i) All sum of money received & expended & matters of receipt / exps.
(ii) All sale & Purchase of goods.
(iii) All assets & liabilities.
(iv) For MSCOS engaged in production, processing & manufacturing their, utilization of materials or labour or other items of cost as may be specified in by-laws of society.

❖ **Qualification of Auditors (Sec. 72):** A chartered accountant under CA Act, 1949.Disqualification:
(i) Body corporate.
(ii) Officer / Employee of MSCOS.
(iii) Partner / Employee of Officer / Employee of MSCOS.
(iv) Indebted / Guarantor for amount > 1000/-

❖ **Appointed of auditors (Sec. 70):**
(i) First auditor by board within one month of registration date to hold office until conclusion of 1st AGM. It board fails then in general meeting.
(ii) Subsequent auditor at each AGM to hold office from conclusion of that meeting until conclusion of next AGM.

❖ **Power & Duties of Auditors (Sec. 73):** Right to access at all times to books, A/C5 & Vouchers to require information & explanation from employee / officers etc.

*Following inquiries shall be made [73 (2)]*
(i) Loans & advances made by MSCOS on basis of security, properly secured & whether terms aren't prejudicial to interest of MSCOS / members.
(ii) Transaction of MSCOS represented merely by book entries are not prejudicial to interest.
(iii) Whether personal Exps. have been charged to revenue.
(iv) In case it is stated in Books of MSCOS that any shares have been alloted for cash whether cash actually been received & if no cash has been so received, whether positions stated in books & B/s are correct & not misleading.

❖ **Contents of Auditors report (Sec. 73):** To member of MSCOS:

**Sec 73 (3):**
(i) B/s. True & fair view of sate of affairs &
(ii) P&L A/c. True & fair view of Profit or Loss:

**Sec 73 (4):**
(i) Whether obtained all information & explanation ………………

(ii) Whether, proper books of A/c kept by MSCOS & proper returns received from branches ……….

(iii) Whether report on A/c of any branch office forwarded to him & how he dealt with the same ……..

(iv) Whether MSCOS's B/s & P&L A/c are in agreement with the books of account & return. Where any matters aforesaid are in negative → reasons.

❖ **Special Audit of MSCOS (Sec. 77)**

- In case Central Government or State Government either alone or both hold 51% or more of paid-up share cap. In such MSCOS.
- Central Government may direct either a C.A or MSCOS's auditor to conducts special audit & make a report to it.
- Cases for special audit:
  - (i) Central Government is of opinion that affairs of MSCOS aren't being managed in accordance with self help & Co-operative principles or sound business principles or:
  - (ii) MSCOS managed in manner likely to cause serious injury / damage to interest of trade / industry or business to which it pertains or
  - (iii) That the financial position of any MSCOS is such as to endeager its solvency.
- Auditor has same powers & duties as in Sec. 73.
- On receipt of report of special audit, Central Government may take such action as it considers necessary.

❖ **Inquiry by Central Registrar (Sec. 78)**

- Central Registrar may:
  - (i) On request from federal co-operation to which MSCOS is affiliated or
  - (ii) A creditor or
  - (iii) At least 1/3 of member of board or
  - (iv) At least 1/5 of total member of MSCOS holds an enquiry or direct some person to enquire into constitutions, working & financial condition of MSCOS. However before inquiry, 15 days notice to be given to MSCOS.
- Central Registrar or person authorised, shall have following powers:
  - (i) Free access to books / A/c / Cash / Properties in custody of MSCOS & summon any person to produce the same at any place specified by him.
  - (ii) Require the officer to call AGM by giving notice of at least 7 days or if officers fail / refuses, he may call it himself.
  - (iii) Summon any person having knowledge to appear before him & examine him on oath.
- Central Registrar with 3 months of receipt of report communicate the report of enquiry to society, FI & to person at whose instance it is needed.

❖ **Inspection of MSCOS (Sec. 79)**

- Central Registrar may ………… (required by same as in case of inquiry)
- Powers:
  - (i) Access to books / sec …………. In event of serious irregularity, take them into custody, verify the cash balance of society & subject to permission of Central Registrar call a meeting, if necessary.
  - (ii) Every officer / member shall furnish information w.r.t. working of society as required by Central Registrar.
- Copy of report within 3 months communicated to MSCOS.

## AUDIT OF MUTUAL FUNDS

⇒ Auditor to be appointed by trustees. Report also forwarded to trustees.

⇒ Every asset, Management Company to keep proper books of accounts, records, etc. for each scheme.

⇒ **Audit Report :**

(i) Obtained all information and explanation.
(ii) Balance Sheet and Revenue Accounts – True and fair view.
(iii) Accounts prepared in accordance with Ninth Schedule.

⇒ **Inspection and Audit :**

SEBI may appoint one or more persons as *inspecting officer* for following purposes :

(i) Books of accounts maintained by Mutual Funds
(ii) Provision of Act complied with.
(iii) System procedures are adequate.
(iv) Provision of Act or rules violated.
(v) Investigate into complaints.
(vi) Affairs are in interest of investors.

❖ **Requirement of Ninth schedule (Mutual funds)**

(i) Mark all investments to market. Thus carry investments in B/s at MV.
(ii) Dividend / Bonus to be recognized on the date when share is quoted on Ex-div / Ex-Bonus basis on S/E. & not on date of declaration.
(iii) For interest bearing investments, interest income must be accrued on a day-to-day basis.
(iv) For determine 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 SP & FV of unit should be credited / debited to reserve. FV being credited to capital A/c. also treatment of equalization A/c is to be taken care of.
(viii) Fore close-ended scheme, the par value of unit has to be adjusted to capital A/c & difference should be to reserves.
(ix) Cost of I 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.

❖ **General clarification**

| Close Ended | Open Ended |
|---|---|
| **1.** Open only for specified period say 45 days in which public may subscribe. | **1.** Open every time. Any one can subscribe them any time |
| **2.** Traded in stock exchange. | **2.** Bought & sold by M.F itself |
| **3.** Daily NAV | **3.** Weekly NAV. |
| **4.** No such account | **4.** Equalisation A/c |

## AUDIT OF DEPOSITORIES

⇒ To maintain following records and documents :
  (i) Record of sec. Dematerialized/re-materialized.
  (ii) Transferor, transferee and date of transfer.
  (iii) Register of beneficial owner (B.O.).
  (iv) Instruction received.
  (v) Approval notice, cancellation or pledge.
  (vi) Details of participants.
  (vii) Details of securities eligible for DEMAT.
  (viii) Other specified by board.

⇒ Intimate SEBI the place of maintaining records and documents.

⇒ Preserve for minimum 5 years.

⇒ If kept electronically, ensure integrity of system and precaution.

⇒ SEBI may appoint one/more inspecting officer for following purposes :
  (i) Ensure that books of accounts maintained by depository, participants, or agents.
  (ii) Look into complaints.
  (iii) Whether provision of Act, Bye-Laws, etc. being complied with.
  (iv) Whether system, procedures followed.
  (v) Affairs conducted in interest of investors or securities market.

⇒ Every issuer shall submit on a quarter basis, the details of changes in share capital during the quarter to the concerned stock exchange. It should be audited by a qualified Chartered Accountant or a practicing Company Secretary. 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 dematerialized form.

## AUDIT OF INDIRECT TAX

⇒ Conducted on behalf of Government.

⇒ For detecting and preventing tax evasion.

⇒ It is for use for -

| **Government** | **Industry & Service providers** | **Consumers** |
|---|---|---|
| (i) Increased Revenue | (i) awareness of changes | (i) Better Tax compliance with reduced tax rates |
| (ii) Less cost of administration | (ii) Tax planning | (ii) Faith of general public |
| (iii) Complete self-assessment | (iii) Corporate governance | |
| (iv) Tax awareness | (iv) Good internal controls | |
| (v) Broader Tax Base | | |

**Methodology :** Evaluation of Internal Control.

↓

Information (historical) of the company.

↓

Audit planning by audit team.

↓

Conduct of Audit

↓

Report on Indirect tax audit.

## SCOPE OF INDIRECT TAX AUDIT

- Non-availment of short/excess availment of Export Incentives.
- Goods imported duty with free or payment at concessional rates, subject to conditions classified incorrectly or without complying with the conditions.
- Transfer Pricing issues.
- Applicability of central excise and availability of exemption on the activity and the products.
- The valuation of goods not removed in normal course using valuation methods not in line with the central excise valuation rules.
- The utilization of goods procured on concessional duty for specific uses/for genral uses.
- The availing of inadmissible cenvat credit and mis-utilisation of credit.
- The passing on of duty suffered on imported goods and of locally manufactured goods in excess of actuals.
- The structural rigidity built into the method of production or marketing and distribution.
- The authorization levels of the indirect tax function, not specifically set out in line with general authorization for the organization.
- Procedural non compliance which could lead to demands and losing of benefits.
- The liability under service tax on services provided being ignored.

## EXCISE AUDIT 2000

(i) All assesses → paying duty ≥ 1 cr. p.a.
(ii) 10 lakhs ≤ duty < 1 crore. → once in two years.
(iii) Duty < 10 lakhs → Maximum 20% of units on rotation basis.

## PROCEDURE OF EXCISE AUDIT 2000

**Selection of Assessee** Risk factor. If bad track record then high priority.

↓

**Desk Review** gather in formation about the assessee without interacting

↓

**Documenting Information** questionnaire

↓

**Touring** Visit the units of assessee to actual running.

↓

**Audit Plan** list vulnerable areas, dynamic plan.

↓

**Verification** conduct of actual audit on a scheduled date.

↓

**Audit objection and Audit Para** if short/non payment. Discuss with assessee . Make objection but not of mere procedural lapse.

↓

**Audit Report** He makes draft report. Discuss with superior officers. Then finalise.

⇒ Excise Audit 2000 good and participative audit. Auditor must be thorough about laws and having good accounts background.

## ENERGY AUDIT

⇒ Activity that serves the purposes of assessing energy use pattern of a factory or energy consuming, equipment and identifying energy saving opportunities.

⇒ Energy Auditors to give recommendation.

⇒ Function of energy Auditor :

(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.

(a) Data collection and analysis

(b) Measurements, mass and energy balances

(c) Reviewing energy procurement practices.

(d) Identification of energy efficiency projects and techno-economic evaluation.

(e) Establishing action plan including energy saving targets, staffing

(f) Recommendations on goal setting.

⇒ Audit team to have representation from various sections.

⇒ A standard of energy/p.u. to be derived then compared with actuals.

### Methodology to Energy Auditing

a. **Preliminary Energy Audit :**

(1) It typically involves two or three days of plan visit.
(2) It is also referred to as walk-through audit.
(3) One may rely on data supplied by the unit or personally read from meters installed in the industry.
(4) In many instances, the meters installed in the industry do not show accurate reading.
(5) Ideally, the energy auditor must carry proper portable instruments and make recommendations.

b. **Detailed Energy audit :**

(1) It goes much beyond the quantitative estimates of cost and savings.
(2) The scope of the audit assignment is discussed in detail with the plant personnel.
(3) The study involves details examination of major energy consuming equipment.
(4) The study proposes specific projects/feasibility study for replacement proposals, providing a cost-benefit analysis of the recommended measures.

## ENVIRONMENTAL AUDITING

⇒ Disclosure of environmentally related data regarding environmental risks its impact, policy target, cost and performance, etc. to interested parties.

⇒ Multi-disciplinary thus conducted by a team of experts from various disciplines.

⇒ Mainly for Internal use.

⇒ 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.

⇒ 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.

⇒ Following aspects should be considered :

2. ***Layout and design :*** Adequate provision for pollution control measures, etc.
3. ***Management of resources :*** It should be used in such a manner to produce best output and minimum waste.
4. ***Pollution Control System :*** It should be in existence.
5. ***Environment Safety Measures :*** like emergency plans, aware, etc. to meet the contingency.
6. ***Medical & Health care facilities :*** Regarding workers.
7. ***Industrial Hygiene :***
8. ***Occupational health :*** According to type of industry.
9. ***Information Assimilation and Reporting System :*** Authorities and responsibilities should be clearly defined.
10. ***EIA Methodology :*** Degradation of Environment and mitigatory measures should be suggested.
11. ***Compliance to Regulatory Mechanism :*** To avoid penalty, etc.
12. ***Concern for the society :***

### AUDIT REPORT FORMAT

1. Name, address, etc.
2. Date of last EAR submitted
3. Consumption of input during current and previous year.
4. Pollution generated and types.
5. Generation of hazardous waste in current and previous year.
6. quantity of sold waste.
7. Disposal practice for waste.
8. Practice for conservation of natural resources
9. Additional proposal for environmental protection.

# PEER REVEIW

- In March 2002,
- To assure that profession is conscious of its responsibilities and strive its best to ensure that highest standards are observed by all practicing members rendering audit and attestation services to the society.
- In involve examination of the systems and procedures of the PU.
- To ensure that in professional assignments, the member of ICAI.
  (a) Comply with technical standard, and
  (b) Have proper system to maintain quality of work.

## PEER REVIEW

| Stage-1 PLANNING | Stage-II EXECUTION | Stage-III REPORTING |
|---|---|---|
| **1.** ***Empanelment of Reviewers***: The reviewer should be member of ICAI having at least 10 years audit experience (cumulative) & currently in practice.<br><br>**2.** ***Intimation to practice unit:*** In writing information of its selection for pear review alongwith a panel of 3 reviewers & a copy of the questionnaire.<br><br>**3.** ***Initial communication by PU*** : Choice of reviewer to board within 15 days from receipt of information . Within 1 month of receipt of intimation, send completed questionnaire along with complete list of client.<br><br>**4.** ***Selection of sample Attestation service engagement:*** Random basis for review. | **1.** ***Initial meeting***: between reviewer & PU to confirm the accuracy of responses to the questionnaire.<br><br>**2.** ***Compliance Review***: that is independence, maintenance of professional skills and standard consultation, staff selection & supervision & office administration to understand working and control procedures of PU.<br><br>**3.** ***Selection of Attestation services Engagements***: He may modify his initial sample selected for review in consultation with the PU at executions stage.<br><br>**4.** ***Review of Records: Compliance & substantive approach:*** Compliance procedure to know worthwhile ness of IC. Then he decided whether to rely on IC or not. In case of rely, his | **1.** **Preliminary Report of Reviewer:** At end of review preliminary report 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 on latter head dated and reviewers signature, membership no. & reviewers code no.<br><br>**2.** ***Reply to Preliminary Report:*** In writing within 21 days from receipt of the preliminary report from reviewers.<br><br>**3.** ***Interim Report of Reviewer:*** If reviewer not satisfied with reply, interim report to Board. The Board recommend to PU & instruct the reviewer to carry out review again after 6 months |

| | | |
|---|---|---|
| **5. *Confirmation of visit***: Reviewer in consultation with PU fix the dates for on site review to complete the peer review process in the four months of receipt of initial intimation to PU. | NTE of sub procedure will be less extensive & vice-versa. Compliance procedure not necessary if size of firm is small/ medium. He may adopt only sub procedure. | to verify whether systems &d procedures have been modified appropriately.<br><br>**4. *Final Report of Reviews***: If reviewer is satisfied with reply of PU. Final report should incorporate the findings. |

## Clause 49 of listing agreement (Corporate Governance)

It is the system by which companies are directed and controlled by the management in the best interest of the stakeholders and other ensuring greater transparency and better and timely reporting (financial).

Entity required to obtain a certificate from auditors for compliance of conditions of corporate governance. This certificate to be annexed to directors report and also sent to S.E. along with annual return.

1. **Board of Directors:** optimum combination of ED & non ED with at least 50% of BOD comprising non ED. If non ED chairman ⟶ At least 1/3 of Board comprise of independent directors else at least ½ of Board comprise of independent directors. Independent director is a non-ED, who fulfills all the following conditions -
   - (i) He shouldn't have (apart from receiving managerial remuneration any other material pecuniary relationship / transaction with the co., its promoters. Management / Subsidiary which (in judgment of Board) may affect independence of judgment of Board.
   - (ii) Not related to promoters or persons occupying management positions at Board level or at one level below the Board.
   - (iii) Not been executive of co. in proceeding 3 F.Y.
   - (iv) Not partner / executive (this year or Pr. 3 F.Y) of (i) Statutory /internal audit firm and (ii) legal / consulting firm having material association with co.
   - (v) Not a material supplier, service provider or customer or lesser / lessee of co.
   - (vi) He is not a substantial shareholder of the company owning 2% or more of block of voting shares.

   Company agrees that all pecuniary relationship / Transaction of non ED vis-à-vis co. shall be disclosed in Annual Report.

2. **Audit Committee**
   - Minimum 3 members (any director) with 2/3 independent.
   - All members financially literate.
   - Chairman independent director.
   - Minimum no. of meetings in a year 4. one meeting before finalisation of A/c Maximum gap between 2 meetings is 4 months.
   - Quorum ⟶ 2 members or 1/3 of members (higher) & out of which minimum of 2 independent director.
   - Co. secretary shall act as secretary of A.C.
   - A.C. to invite financial executive of co. in its meeting. However, they can meet without his presence too.
   - A.C
     - (i) Will maintain laison with Co. & auditor. Consider:
       (a) Matter to be included in directors responsibility statement.

(b) Review functioning of whistle blower mechanism (if any).

(c) Review performance of statutory / internal auditors.

- AC Mandatorily review →
  - (i) Management discussion & analysis of financial statements.
  - (ii) Statement of significant related party transaction.
  - (iii) Management letter / letters of IC weaknesses issued by statutory auditors.
  - (iv) Internal audit reports relating to internal control weaknesses.
- Appointment / Removal / Terms of remuneration of chief internal auditor.

3. **Remuneration of Directors:** Remuneration of non-ED decided by BOD, after obtaining prior approval of shareholders. If stock option to non-ED. Limit for maximum no. to be granted to non-ED in one F.Y. & in aggregate to be disclosed alongwith disclosure of elements of remuneration package. Details of incentives, service contract in annual report.

4. **Board procedures:** Meeting 4 times a year with maximum gap 3 months between two meetings. Code of conduct for Board / Senior management laid by BOD. A director not to be a member in more than 10 committees or chairman in more than 5 committees across all companies in which he's is a director.

5. **Management:**
   - (a) Management discussion & analysis report should form part of annual report.
   - (b) Disclosure of all material transaction having personal interest, having potential conflict with interest of the company a large.

6. **Shareholder:** In case of Appointment / RE-appointment of a directors, shareholders must be provided with its brief resume, nature of this expertise & names of companies in which he holds directorship.
   - (a) Shareholders: Information like quarterly results to be put on companies web-site or on S.E's site.
   - (b) Shareholders: Board committee under chairmanship of non-E.D to look into redressing of shareholders & investors complaints.
   - (c) Shareholders: To expedite the process of share transfer this work to be delegated to an officer or share transfer agent.

7. **Subsidiary Company:**
   - (i) At least one independent director of holding company shall be a director in material non-listed Indian subsidiary company.
   - (ii) AC of holding shall review the financial statement (particularly investment) by unlisted subsidiary company.
   - (iii) Minutes of Board meeting of unlisted subsidiary company to be placed at board meeting of holding co.

8. **Disclosures:**
   - (i) Statement on transaction with related parties in ordinary course of bussiness/not in ordinary course of business to be placed before A.C.
   - (ii) Details of transaction with related parties or other not on arms length to be placed before A.C. with management justification.
   - (iii) Financial Statement to disclose (with management explanation) A/C treatment difference from A/C standard.
   - (iv) Procedure to inform Board risk assessment & its minimization procedures.
   - (v) Company to disclose Audit Committee (quarterly) use of funds raised through issue.
   - (vi) Criteria for making payment to non-ED.

9. **CEO / CFO Certification :** The CEO and the CFO or any other person heading the finance function discharging that function shall certify to the 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 :

i) these statements do not contain any materially untrue statement or omit any material fact.

ii) These statements together present a true and fair view of the company's affairs.

(b) There are no transactions entered that are fraudulent, illegal and violative of the company's code of conduct.

(c) They accept responsibility for establishing and maintaining internal controls.

(d) They have indicated to the auditors and the Audit committee

i. Significant changes in internal control during the year;

ii. Significant changes in accounting policies during the year.

iii. Instances of significant fraud.

**10. Report on Corporate Governance :**

There shall be separate section on Corporate Governance in the Annual Reports of company with a detailed compliance report on Corporate Governance.

11. **Compliance :** The company shall obtain a certificate either from the auditors or practicing company secretaries regarding compliance of conditions of corporate governance.

| Clause 49 of Listing Agreement | Section 292A of the Companies Act, 1956 |
|---|---|
| 1. (a) For entities seeking listing for the first time, at the time of seeking in principle approval for such listing. | Every public company having minimum paid up capital of rupees five crore, shall constitute an audit committee immediately on the enactment of Companies (Amendment) Act, 2000. i.e., with effect from December 13, 2000 |
| (b) For existing listed entities which were required to comply with Clause 49 which is being revised, i.e., those having a paid up share capital of Rs.3 crores and above or net worth of Rs.25 crores or more at any time in the history of the company, by April 1, 2005. | |
| 2. The audit committee having minimum three directors as member. Two thirds of the members of audit committee shall be independent directors. | The audit committee shall have minimum three directors of which two-third of the total number of such directors shall be directors other than managing or whole time directors |
| 3. the Chairman of the Audit Committee shall be an independent director | The members of the Audit Committee shall elect a Chairman for amongst themselves. |
| 4. A representative of the external auditor, when required shall be present as an invitee for the meetings of the Audit Committee | The auditors shall attend and participate at meetings of the audit committee. |

# AUDITING UNDER VAT

1. VAT is a tax on the value added to the commodity at each stage in production and distribution chain.
2. VAT is an indirect tax on consumption.
3. The total amount of tax, which is to be collected at the final, or retail point of sale, is collected in instalments.
4. Major states who have introduced VAT have generally incorporated audit provisions in their VAT legislation.
5. Section 61(1) of the Maharashtra Value Added Tax (Levy and Amendment) Act, 2005, requires the dealers, having sales or purchases exceeding Rs.40 lacs, to get their accounts audited by a Chartered Accountant.
6. The following steps required to be taken by the auditor while auditing under VAT.
   - **(a)** *Knowledge of Business :* The auditor should refer AAS – 20 'Knowledge of the Business' issued by ICAI. The auditor to 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 Auditor :* 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 internal check system in operation in the entity.
   - **(e)** *Obtaining the list of all the Accounting Record Maintained by the Auditor:* The auditor should obtain a complete list of all the accounting records relating to sales/purchase of goods.

## AUDIT PROGRAM

- i. 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.
- ii. 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.
- iii. 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.
- iv. The auditor should apply tests as will enable him to ascertain whether the auditee is eligible for composition.
- v. The auditor may also be expected to check the consolidation of the returns filed for all the periods covered in the year under audit.

vi. 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.

### AUDIT REPORT UNDER THE VAT LAW

At the end of the audit the auditor has to arrive at his conclusion on the mattes 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.

## AUDIT OF MEMBERS OF STOCK EXCHANGE

Every active member shall get his accounts audited by a chartered accountant.

Company can also become a member of stock exchange.

SEBI may levy monetary fine & penalties on any person in following cases:

(i) Failure to furnish document information etc. required by Board

(ii) Failure to maintain books of accounts/returns.

(iii) Failure by sponsor of any collective investment scheme including M.F. to obtain registration certificate. To comply with terms of such certificate, to dispatch unite certificate, to refund application money, to invest money in desired manner & in specified securities.

(iv) Failure to Issue contract notes in form required, to deliver security, make payment to client, charging excess brokerage.

(v) Failure to enter into agreement with client.

(vi) Person dealing/communicating on basis of price sensitive information.

(vii) Failure to disclose aggregate of shareholding in body corporate before acquiring furthers share & to make public announcement to acquire share at minimum price in case of takeovers.

Business at S.E. can be transacted only by its members. They enter into transaction either on their own behalf or their clients or sub-brokers.

### MARGIN

1. Due to wide fluctuations in prices of securities over a period of time, the exchange levies margin on its members.
2. This certain deposit is to be kept with exchange by its members.
3. This mechanism is adopted, in order to restrict excessive speculations and safeguard the interest of the investors.
4. The members are required to collect margins from their clients and deposit it with the clearing house of exchange.
5. The three types of margins are –

**1. Volatility Margin :**

(a) The volatility margin is imposed to curb excessive volatility in the securities.

(b) It is also used to prevent building up of excessive outstanding positions.

(c) This margin is calculated at the discretion of stock exchange to charge margin on any particular security because of its volatile nature, on specific percentage.

**2. Gross Exposure Margin :**

(a) It is the percentage of net cumulative outstanding position in each security that the member should keep with the exchange at all times.
(b) This margin is calculated on continuous basis.
(c) This margin is to be kept with stock exchange in advance.
(d) Gross exposure is calculated on all securities unlike volatility margin which is on any specific security.

**3. Mark to Market Margin :**

(a) This margin is imposed to cover a loss that a member may incur in case the transaction is closed out at the closing price of the trading day, which is different from the price at which the transaction has been entered into.
(b) 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.

**TYPES OF MARKET**

There are four types of market.

I. **Normal Market –** All orders which are of the regular lot size or multiples thereof are traded in the Normal Market. For D-mat shares, lot size is 1 share.

II. **Odd lot Market –** An order is called an odd lot order if the order size is less than the regular lot size, such orders are traded in the odd lot market. But for order matching both price & quantity should tally with each other.

III. **Spot Market –** in all respects spot orders are similar to the normal market orders except that spot orders have different settlement periods vis-à-vis normal orders. Pay in pay out takes place on the same day.

IV. **Auction Market –** Stock exchange on behalf of their members initiate auctions to purchase from the market, the number of shares short deposited by the members. In this way, they complete the settlement process. Loss is recovered from members but profit it any deposited to investors education & protection fund.

**TYPES OF ORDER BOOKS**

As has been explained above, a member has various options regarding the type of order he wants to place. When an order is received it is given a unique number and a unique time stamp. In case, an order could not be matched, then they are stored in a different book in price – time priority in the following sequence.

- Best price
- Within price, by time priority.

Thus when two orders are entered at the same time the one with a better price gets priority. Similarly, incase two orders were entered at the same price; the one which was entered earlier gets priority.

**The following types of books are maintained in the Capital Market**

i. **Regular Lot Book –** This book contains only regular lot orders and order do not have any of the following attributes attached to them.

- All or Non (AON)
- Minimum fill (MF)
- Stop Loss (SL)

ii. **Special Term Book –** All the orders, which have any of the following attributes, are recorded in this book. They are –

- All or NON (AON)
- Minimum Fill (MF)

**iii. Stop-Loss Book –**

- Stop loss orders are stored in this book till the trigger price is reached or surpassed.
- When the trigger price is reached or surpassed, the order is released in the regular lot book.
- The stop loss conditions are met under the following circumstances.

  - **Buy order –** a buy order in the stop loss book gets triggered when the last traded price in the normal market reaches or exceeds the trigger price of the order.
  - **Sell order –** a sell order in a stop loss book gets triggered when the last traded prices in the regular market reaches or falls below the trigger price of the order.

iv. **Odd Lot Book –** The odd lot book contains all orders with lot size lesser than the marketable lot.

v. **Spot Book –** The spot book contains all orders having different settlement periods only. The system attempts to match an active spot order with a passive spot order in the book.

vi. **Auction Book –** Auction Book contains orders that are entered for all auctions.

**ORDER MATCHING RULES**

(i) The best buy-order is matched with the best sell order.

(ii) It is obvious that a seller would like to sell at the highest available price.

(iii) Thus, the best buy-order is the one with the highest price.

(iv) At the same time, a buyer would like to buy at the lowest available price.

(v) Thus the best sell-order is the one with the lowest price.

(vi) Thus the trading system tries to find for the seller the best possible buying price and the best possible selling price for the buyer.

**Order Matching Rule**

| Buy | | Sell | |
|---|---|---|---|
| **Qty** | **Price** | **Qty** | **Price** |
| 500 | 38.90 | 200 | 39 |
| 400 | 38 | 500 | 40 |
| 100 | 37 | 700 | 41 |
| 1000 | 36 | 200 | 41.50 |
| 300 | 35.50 | 1000 | 42 |
| **Best price (Buy) highest** | | **Best sell (lowest price)** | |

(vii) Orders that match with other orders are called ‘active’ orders while those, which do not match, are called ‘passive’ orders.

(viii) The system always matches orders with passive orders in order to clear earlier orders on priority basis.

**Order conditions :** The order matching conditions fall into three categories

i. Time Related conditions
ii. Price related conditions
iii. Quantity related conditions

**i. Time Related Conditions**

a. **Day order –** A day order is valid only for the day on which it is entered. It gets automatically cancelled if not matched by the end of the day.

b. **Good till cancelled order –** A GTC order remains in the system until it is cancelled by the trading member. The maximum number of days for which a GTC order is valid is notified by the concerned stock exchange.

c. **Good Till Days/Date order (GTD) –** In such orders the trading member specifies the days / date upto which the order shall remain valid. The stock exchanges specify the maximum permissible term of such orders.

d. **Immediate or Cancel orders (IOC) –** An IOC order allows a member to buy or sell a security as soon as the order is released into the system, failing which the order is cancelled. If it is partially matched remaining quantity is automatically cancelled.

ii. **Price Related Conditions**

a. **Limit Price order –** An order where the trader specifies his offer price is called a limit price order.

Buyer – Max price upto which he is willing to pay.

Seller – Minimum price is which he ready to sell.

b. **Market price order –** An order t buy and sell securities at the best market price at the time of placing the order.

c. **Stop loss price order –** Stop loss price orders get activated when the market price reaches or crosses a threshold price specified in the order *(refer stop loss book)*.

iii. **Quantity Related conditions**

a. **Disclosed Quantity Order (DQ) –** A DQ order allows a trading member to disclose only part of the order quantity to be displayed. For example in a buy order for 500 units only 100 units will be disclosed, when these are purchased the buy order for the next 100 units are disclosed to the market.

b. **Minimum fill orders (MF) –** Minimum fill orders allow the members to specify the minimum quantity by which an order should be filled.

c. **All or None order (AON) –** All or none orders allow the members. Put the order into market with the condition that only whole quantity should be matched.

d. **Short Sell –** The seller sells the shares even if he doesn't own then. 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.

**SETTLEMENT SYSTEM AT STOCK-EXCHANGES**

- There are two types of settlement systems that can be adopted in stock exchanges – Accounting period system and rolling settlement system. Now-a-days, stock exchange in India adopts rolling settlement only.

a. **Accounting period settlement systems -**

- There is a predetermined period of usually 7 – 12 days, over which total trades are aggregated.
- Cumulative net obligations of each member are calculated on last day of cycle.
- It is more speculative than the rolling settlements. It may lead to payment crisis in case of wide fluctuations in the market.

b. **Rolling Settlement**

Each day constitutes an accounting period and that days traders are settled after 2 – 3 days.

(T + 3) rolling settlement was in operation in India upto 31$^{st}$ March, 2003, which was switched on to "T+2" rolling settlement system from 1$^{st}$ April, 2003.

Trades o/s at end of day are to be settled with 'X' business day form transaction.

T+2, transaction on Monday pay in & pay out takes place on Wednesday.

Trades on each single day settled separately from trades done earlier or subsequent trade days.

Netting of trades is done only for the day & not for multiple days (as earlier in settlement period).

It adopts VAR (Value at Risk) based margining approach.

If member fails to deliver shares sold the exchange conducts an auction session on T+3 to meet short fall due to non-delivery.

**Derivatives**

It has two mechanism futures & options.

Contracts are available for trading with one months & three months expiry.

TM (Trading member) & CM (Clearing member)

CM – (i) TM – CM (Both)
(ii) PCM (professional CM)

Premium is paid on entering each option.

Trading in index options also available.

## AUDIT OF ACCOUNT

All active members of stock exchanges are required to get their accounts audited by a Chartered Accountant. Active member is any member who has conducted business in securities even for a single day in the year.

**Books of Accounts and other Documents Subjected to Audit**

A member holding membership of many stock exchanges or different segments of same exchange (derivatives/capital market segment), he has to maintain separate records and documents with respect to each exchange or each segment.

A member of the exchange is required to maintain the following books of accounts –

- Register of transactions / Sauda Book
- Clients ledger
- General ledger
- Journal Register
- Cash Book
- Bank pass book
- Documents (received / delivered) register
- Members contract book showing details of all contracts entered into by him with other members of the same exchange.
- Counterfoils or duplicates of contract notes issued to clients.
- Written consent of clients to the contracts entered into as principals.
- Margin deposit book.
- Register of accounts of sub brokers.
- Copies of agreements with sub-brokers.
- Copies of margin statements down loaded from the exchange.
- Details of spot delivery transactions.
- Clients database and member client agreement.
- Copy of registration certificate of each sub-broker.
- Copy of the power of attorney / board resolution authorizing the directors / employees to sign the contract notes.
- Copies of pool account statements.

**Audit Procedures**

1. **Daily Transactions List (Sauda Book)**
   This is the basis record maintained by the member containing details of all transactions entered by them on a daily basis. It contains information on
   - Name of the client
   - Securities traded on behalf of client

- Rate and quantity of securities bought and sold.

Daily transaction register contains a record of all the following categories of transactions

i. Member's own business on the exchange
ii. Member's business on behalf of his clients
iii. Member's business with his clients on a principal to principal basis
iv. Member's own business with member's of other stock exchanges
v. Member's business on behalf of his clients with members of other stock exchanges
vi. Spot transactions

2. **Contract Notes**

Every member of the stock exchange has to issue contract notes to its clients for all business executed on their behalf within 24 hours of the execution. In reference to contact notes, the auditor should ensure that

i. Contract notes are serially numbered
ii. These are in the format prescribed by relevant exchange.
iii. Brokerage has been charged within specified limits and shown separately
iv. Ordering time should be reflected on contract notes along with the time of execution of order.
v. Member/authorized signatory should sign contract notes.
vi. Brokerage, Service tax & security transactions tax shown separately.

3. **Client bills**

(i) It contain summary of all trades executed on behalf of the client during a period.
(ii) It shows the net amount receivable from or due to the client.
(iii) The auditor should ensure their proper postings.

4. **Clients ledger**

It contains transactions with each client. The auditor should examine

i. Transactions remaining unsettled for a long time.
ii. Whether amounts received from clients is consistently different from the contract bills.
iii. That amounts received or paid as loans or deposits have not been passed through clients ledger.
iv. Confirmation of balances received from clients of the member.

5. **Settlement / Vallan control account**

(a) It shows the net amount receivable from or payable to the exchange or clearing house.
(b) The auditor should verify that balance in this account is nil after settlement.
(c) If not reconciliation should be obtained.

6. **Margin Deposit Book**

It records the margin deposited by the member with the Clearing house.
The auditor should check

i. Whether margin has been in accordance with SEBI guidelines.
ii. The margin statement downloaded from the stock exchange / clearing member should be verified.
iii. Whether margins have been properly calculated, collected and paid
iv. Any exemptions from deposit of margin for particular trades available to the members

7. **Member's own Trading Account**

(a) The auditor should verify the entries with the bills raised for trading on own account.
(b) He should also ensure that there is a proper system for revenue recognition and closing stock from such transactions.

(c) No brokerage is charged on this account.

8. **Bank book**
The member holds a fiduciary position in the security trading system and hence certain restrictions are imposed on the operation of the bank account in respect of his clients. According to these restrictions –

**A.** No money be paid into clients account other than
   i. Money held or received from clients
   ii. Money for replacement of withdrawal by accident from such account.

**C.** No money can be paid from clients account other than
   (i) Settlement with the client
   (ii) Payment to clearing house on behalf of client
   (iii) Money for replacement of deposit by accident into such account.

9. **Documents Register / (Inward / Outward) Register**
It contains particulars of securities including their distinctive numbers received from or delivered to the client in physical form. With regard to documents register, the auditor should check
   i. Balance of stock as shown in deposit register segregated into client stock and own stock.
   ii. The reasons for client's stock remaining with the member for a long time.
   iii. The auditor should also physically verify the stocks.

10. **Dematerialized securities**
   (a) Now-a-days, most of the securities have been converted into dematerialized form because of benefits of electronic trading system.
   (b) Under this system, each member has to maintain two demat accounts.
   (c) One of these is used to hold its own securities and known as "Beneficiary Account".
   (d) The other one, 'Pool Account', is meant for trades executed on behalf of clients.
   (e) The securities meant for sale are transferred to the 'Pool Account' from where these are given to the clearing house on the relevant pay in day.
   (f) The audit procedures should include
      i. whether securities received n pool account have been transferred to client's Demat Account within 48 hours.
      ii. Reasons for holding a particular security in pool account for an unreasonable time.
      iii. Ensuring that securities lying in pool account have not been used to settle member's own trade obligations.

**Audit Report:**
(i) We have audited B/s & P&L a/c of ..........
(ii) Obtained all information & explanation
(iii) Proper books of a/c & records specified by securities contracts (regulation) rules are kept.
(iv) Broker complied with requirement of exchange . So for as they relate to maintenance of a/c & was regular in submitting req. information to S.E.
(v) In our opinion & to best of our information ... (true).

**Matters to be considered by SEBI while granting registration to a prospective stockbroker:**
1. Is eligible to be admitted.
2. Has necessary infrastructure.
3. Has past experience in business of securities.
4. Is not subjected to in disciplinary proceedings by stock exchange.

**Hit or take orders**
(i) These are a variations of market orders.
(ii) Faster order execution.
(iii) For the quantity specified, the system attaches the counter touchline price to it.
(iv) The order will be matched while all unexecuted orders of this type are automatically killed.

**Bought out deals**

(i) Companies may place its equity intended to be offered to be public with a sponsor member at a mutually agreed price through the Concept of Bought out deal.

(ii) Thus after buying out the total equity. Sponsor member would sell the shares of the company to the public through "offer for sale".

(iii) It ensures faster availability of funds to the company for timely completion of its projects and also a listed status on a later date.

**Circuit Breakers**

Individual security wise | Market wide

**1. In securities:**

(a) To curb excessive volatility.

(b) May be 2%, 5%, 10% or 20% based upon categories of shares.

(c) It is calculated w.r.f closing price of previous trading day.

(d) For example, if on 13-06-2005 the closing rate of AFTEC INFOSYS is Rs. 100 the price band in case of 20% circuit breaker is 80 (Lower freeze)and 120 (upper freeze).

**2. Market wide C.B.**

(a) W.e.f 02-07-2001.

(b) 3 stages of index movement 10%, 15% and 20%

(c) It brings about trading halt in market nationwide (all markets)

(d) The % are calculated into absolute points of index variations on quarterly basis, based upon closing index of last day of trading in a quarter.

(e) So far only twice in Indian history

(f) 17th May, 2004 **[Black Monday]**
22nd May, 2006

**Movement**

| 10% | 15% | 20% |
|---|---|---|
| Before 1 pm – 1 hour halt 1– before 2:30 pm – ½ Hr. halt<br>On or after 2:30 – No halt | Before 1 pm – 2 hour halt<br>1 – before 2 pm – 1 hour halt<br>on or after 2 pm – halt for remainder of day. | Halt for remainder of the day. |

Depending upon time of index movement & its percentage trading may be halted for specified time period.

**Depositories and Dematerialisation :**

(a) NSDL & CDSL keep record of ownership of securities electronically in book entry form.

(b) Transfer of ownership of securities is done by simple account transfers.

**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.
(VIII) Easy settlement with clearing house.

**Clearing and Settlement Mechanism**

1. the securities pay-in obligations of members are downloaded by the clearing agency.
2. The members make available the required securities in their pool accounts with Depository Participants (DPs) by the prescribed pay-in time for securities.
3. The depository runs an electronic file to transfer the securities from the pool accounts of members with DPs to the DP account of the clearing agency.
4. The securities are transferred on the pay-out day by the depository from the DP account of the clearing agency to the DP accounts of members.
5. Select banks have been empanelled by clearing agency for electronic transfer of funds.
6. The members are informed electronically of their pay-in obligations of funds.
7. The members make available required funds in their accounts with clearing banks by prescribed pay-in day.
8. Same way, funds are transferred on the pay-out day by the clearing banks from the account of the clearing agency to the accounts of members.

# MANAGEMENT & OPERATIONAL AUDIT

**MANAGEMENT AUDIT :**

"M.A. concern 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*

⇒ It is *audit of management.*
(Management Audit = Op. audit + Review of adequacy and competence of top management).

⇒ Primary accent is on evaluating managers ability to manage.

***Scope of Management Audit***

1. Purposes of organization.
2. Management Structure.
3. Reports required by the management.
4. Internal controls.
5. Nature of production of Business.
6. Production planning.
7. Factory layout, design and installed capacity.
8. Personnel policy.

9. Material management.
10. Sales management.
11. Decision making process.
12. Books and Records.
13. Financial Managements.

Thus, management audit includes all the elements of op. audit also.

## ***Need / Desirability of Management Audit***

1. **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.
2. **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 utmost efficiency.
3. **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.
4. **Public sector undertakings –** In such PSUs mostly problems occur because of poor management which may be improved by conducting management audits.

## ***Organising Management Audit***

(1) Devising statement of policy.
(2) Location of audit function within organization or outside
(3) Allocation of personnel.
(4) Staff training program.
(5) Time and other aspects.
(6) Frequency.

## ***Conducting Management Audit***

⇒ Getting facts through interview.
⇒ Measuring performance through Management Audit questionnaire.
⇒ Concluding it.
⇒ Oral recommendation for improvement.

## ***Management Audit Reports***

(1) ***Oral Reports*** *:* emergency wants. However not considered reliable. No permanent record but corrective steps can be taken immediately.
(2) ***Interim written report*** *:* If it is advisable to inform management before regular report for their early consideration.
(3) ***Regular written reports*** *:* formal report at end of work, may be short or long.
(4) ***Summary written report*** *: "Flash'* reports summarizing various individual reports. For top management. Integrated approach. It facilitates management by exception because management (top) has not time to go to through those lengthy individual reports.

## ***Organisation of written report***

**(1) Format :**

(i) Title
(ii) Objectives.
(iii) Scope.

(iv) Findings, conclusions and opinions.
(v) Recommendations.
(vi) Auditee's view.
(vii) Summary.

### ***Behavioural Aspects in Management Audit***

Financial auditor deal with figures, Management auditor with people.

⇒ Colleagues in own department.
⇒ Staff of auditee department
⇒ Top management.

*Causes :*

1) **Staff** / **line conflict** : Management Auditors are staff, thus line unhappy.
   ***Reasons***
   **(i)** Normally staff has superiority complex they don't wonna understand line considering it to be inferior.
   **(ii)** Staff may give irresponsible advice without judging its feasibility.
   **(iii)** Line doesn't co-operate with staff.
   **(iv)** Line doesn't provide sufficient information to staff.
   **(v)** Line doesn't use staff advice property.
   **(vi)** Staff has fault finding advice.
   **(vii)** Staff doesn't consider line before advising.

2) **Control** : Auditee fear that his actions will have adverse effect on top management. They have → fear of criticism, → fear of changes and → punitive actions due to – (i) insensitive audit practices and (ii) Hostile audit style.
3) **Changes** : Resistance to changes. Auditor's recommendation for changes to which auditee resists.

### ***Solution to such problem***

1. For constructive benefit.
2. Maximum service.
3. Minimum interference with regular op.
4. Officers should be informed and review findings with them before submission of formal management audit report to top management.
5. Trust and friendly atmosphere.
6. Constructive criticism.
7. *Reporting Methods :* Participative. Suggest with those who have to implement them.
8. Right management culture, good auditee and right auditor.

### ***Three cases***

1. Auditor Objective
   Auditee Offensive
   Management indifferent.

2. Auditor cantankerous
   Auditee progressive.
   Management indifferent.

3. Auditor progressive
   Auditee participative.
   Management objective.

## Management Audit / 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."

- T.G. Rose

"*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 |

Types of operational Audit

1. **Functional Audits:** Function are means of categorisation of activities of a business. It deals with functions of an organisation. Function audit requires specilisation by auditor. For e.g.:- production, payroll.
2. **Organisational** Audits: To emphasis how efficiently & effectively functions interact.
3. **Special Assignment**: At the request of Management For e.g.:- causes of ineffective IT system.

**Differences between Financial / Operational Auditing**

1. **Purpose:** opinion on financial information / effectiveness & efficiency of operations.
2. **Area**: only financial statements / all activities
3. **Reporting**: to all shareholders, bankers / to management.
4. **End Task**: reporting / suggestions.

| Financial | Operational |
|---|---|
| **1.** Opinion on financial information. | **1** Opinion on effectiveness & efficiency of operation |
| **2.** Only financial information | **2** All activities |
| **3.** Report to shareholders | **3** Report to management |
| **4.** It ends in report | **4** It ends in report including suggestions |
| **5.** By C.A | **5** By team of expert |
| **6.** By independent | **6** May be by is house team |
| **7.** Compulsory | **7** Optional |
| **8.** Yearly | **8** It depends |
| **9.** Old concept | **9** Comparatively new approach |

***Need for Operational Audit because –***

(1) Executives → no time to collect information and locate problems. Preoccupied with their own problems.
(2) Managers generally relied upon.
(3) Information transmitted by managers → biased.
(4) Conventional nature of internal audit report and mechanical nature, as it does not provide recommendations.
(5) Other reports (performance) → own limitation.

(6) Operation of control → no idea of environmental condition. Whereas the operational auditor is always supposed to be open-minded.
(7) Survey → costly, time consuming.

### ***Objectives of Op. Audit***

1. **Appraisal of control** – Internal controls provide the essential means to ensure proper performance in each functional or organizational area for accomplishing the desired organizational objective. Operational auditing deals with the administrative controls and its purpose is to determine whether the controls are adequate.
2. **Evaluation of performance –** During performance evaluation, an operational auditor is heavily dependent upon availability of acceptable standards.
3. **Appraisal of objectives and plans –** Though controversial, one school of thought holds that operational auditing can be stretched to evaluate management objectives and plans. If the management policy favours installation of controls, controls would have to stay within the policy frame. Therefore, the basic things that should be evaluated is management policies, plans and objectives.
4. **Appraisal of organization structure –** Organisational structure provides the line of relationship and delegation of authority and tasks. This is also another important area for appraisal by the operational auditor.

### ***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.*

### ***Difference between the two***

**A. Perception :**
Traditionally, Internal auditors appraised financial and A/c. controls. But gradually started covering non-A/c. control as well. However, approach is to examine the same from monetary point of view only. For e.g. → To Internal auditor loss of Rs.1,000 because of wrong totaling is important but for operational one, carrying of maintenance program of machine is more important. Thus, difference in approach. While the Internal auditor's approach (Traditional) is about monetary / Quantitative terms. Operational Auditor give more importance to the qualitative aspect (*viz.* attending to customers complaints, etc.).

B**. Issues :** According to few, area of operational audit is young while Internal audit is old concept. Extension of scope of operational audit to recommendation of specific changes. As per Lindberg & Cohn, operational auditors shouldn't involve in installing systems and controls of operational areas whose audit they're expected to perform. Same way, as per Institute of Internal Auditors. Internal auditor should also be completely objective in his approach. Thus, we can understand operational audit as an extension of internal auditing with definite work content stretching beyond traditional field of internal auditors (*financial A/c.)* Every aspect of operational audit, however, is towards management policies, management objects and goals only.

C. **Objectives** : operational auditor try to verify fulfillment of plans and other requirements and focus on objectives and their achievement. Having good knowledge of business aspects. Open minded, well acquainted with performance yard-sticks, which he apply with suitable adjustments. Now, the modern definition of Internal auditing is broad enough to embrace the areas covered by operational auditing as well.

## REVIEW OF SYSTEMS AND PROCEDURES

***Systems –*** System is defined as a set interrelated components which work together to accomplish a common objectives.

**Procedures –** Procedures are the means by which policies are implemented. Procedures entail the use of documents in accordance with precise instructions or methods to be used. Standard procedures facilitate control of business operations.

**Review of Systems and Procedures** – The review of systems and procedures is undertaken to improve the methods, to get away from the old ways and traditional routines and to reduce the cost in completing the processing the paper work – eliminating waste, duplication and inefficiencies.

The important thing in the evaluation of systems and procedures is to make sure that they are designed to produce the desired results in the context of activities / operation of the organization. All deviations must be called to the attention of different levels of management depending upon the importance of seriousness of deviations.

The evaluation of a system or procedure actually includes three separate considerations. First, is the system of procedure meeting all of the current requirements ? Second, is it operating effectively ? and third, what is the degree of effectiveness ? 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 adequately 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 indicate 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 ?
vii. Has the necessary authority been designated to carry out responsibilities ?
viii. Can any changes be made to improve effectiveness ?

**Management Audit Questionnaire**

| Manufacturing including Purchasing function | Marketing | Personnel |
|---|---|---|
| **(i)** Manufacturing overview<br>**(ii)** Production planning<br>**(iii)** Production<br>**(iv)** Inventory<br>**(v)** Purchasing | **(i)** Marketing overview<br>**(ii)** Sales<br>**(iii)** Mark of research<br>**(iv)** Advertising<br>**(v)** Physical Distribution | **(i)** Personnel overview<br>**(ii)** Manpower planning<br>**(iii)** Industrial Relations |

For each of sub heads following points must be mentioned:

**(a)** Long-range plans
**(b)** Short or medium range plans
**(c)** Organizational structure
**(d)** Leadership
**(e)** Communication

**(f)** Control.

# INVESTIGATIONS

## INVESTIGATION AND AUDIT

Investigation implies systematic and critical examination of accounts and record of a business enterprise for a specific purpose. The specific purpose may be evaluation of state of affairs or establishing of a fact

| AUDIT | INVESTIGATION |
|---|---|
| 1. General | 1. Specific |
| 2. Opinion | 2. Fact |
| 3. No doubt | 3. Doubt |
| 4. 1 year | 4. No fixed period |
| 5. St. requirement | 5. It depends |
| 6. C.A | 6. Any person |

## STEPS IN INVESTIGATION

1. Determine scope/objectives of Investigation
↓
2. Formulate Investigation programme.
↓
3. Examine/Study various records.
↓
4. Analysis, interpretation of finding
↓
5. Preparation of report.

***Special Issues in Investigation :***

1. Whether investigator to undertake *100% / Selective verification* :

   It depends on circumstances. For cash defalcation (100%) / Profitability (selective basis).

2. Whether he can put *reliance on audited statements* :

   It depends. If doubt in audited statement, then no reliance but for amount of g/w, he may rely for selective information.

3. For obtaining *opinions of experts :*

   Get the written consent of client before referring.

4. Case arises out of *dispute / conflicting claims* :

   He should be objective and professional.

5. *Refrain* from issuing *speculative opinion.*

6. *Refuse* to be *futuristic.*

7. Retain all *working papers.*

## BUSINESS INVESTIGATIONS

C.A. may be requested to the study of financial statements and asked to report on them. Financial statements comprise of profit and loss account and balance sheet. He should take care to consider the following :

- **Profit and Loss Account –** Study or 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.

  1. ***Depreciation:***
     - **(i)** Whether adequate depreciation has been provided on a consistent basis.
     - **(ii)** Incase of revaluation of assets, depreciation should be provided on revalued amount and over their estimated useful life.
     - **(iii)** For 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.
  2. ***Turnover :***
     - **(i)** Turnover of the company should be segregated between various products, types of customers, territory etc.
     - **(ii)** Order books should be examined to identify and eliminate fictitious entries.
     - **(iii)** Income and expenses should be broken proportionately between manufacturing and trading operations.
  3. ***Wage Structure :***
     - **(i)** Method of computing wages and rate of wages should be checked.
     - **(ii)** Any unusually high wage payment should be analysed.
     - **(iii)** If the business has suffered labour disturbance in the past then it should be checked whether a long lasting settlement has been reached.
  4. ***Managerial remuneration:***
     - **(i)** Check that remuneration payable is not excessive
     - **(ii)** It should be in accordance with the provisions of Companies Act, 1956.
     - **(iii)** Even if no or nominal remuneration has been paid, it should be adjusted to arrive at true profitability.
  5. ***Exceptional and non-recurring items:*** These items disturb the trends of the profits. Therefore, the effect of these items along with their tax implications should be adjusted to arrive at maintainable profits.
  6. ***Repairs and Maintenance:***
     - **(i)** Major repairs and over hauling jobs are generally undertaken at any interval of 3 to 4 years. It should be ensured that these expenses have been systematically appropriated over a period of time. (However, take care of Accounting Standard – 26).
     - **(ii)** It should be correctly broken into capital and revenue expenses.
  7. ***Unusual year:*** Investigating accountant should eliminate results of one or more years which disturbs the trend due to exceptional factors, while arriving at maintainable profits.

- **Balance Sheet:**

  The elements of Balance sheet may be studied as under –

  1. **Fixed Assets –** Fixed assets may be studied as regards with
     - **(i)** Age of fixed assets in order to determine replacements that may be required in the future.
     - **(ii)** Incase 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.
     - **(iii)** Incase of revaluation of fixed assets, depreciation should be provided on the revalued amount.

2. **Investments –**
   - **(i)** Current investments should be valued at market price.
   - **(ii)** Long term investments should be valued at cost. However, a permanent decline in value should be provided.
   - **(iii)** Pre-acquisition profits should be reduced from cost of investment.

3. **Debtors –**
   - **(i)** 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.
   - **(ii)** 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.
   - **(iii)** Age – wise classification of debts helps in understanding the nature of customers and working capital requirement of business.

4. **Stock and work in progress –**
   - **(i)** These assets should be consistently valued as per generally accepted accounting policies.
   - **(ii)** Due allowance for damaged, obsolete and show moving items should be made.

5. **Other liquid assets –** These assets include cash in hand and readily realizable bank balances. It is prudent to insure cash in hand.

6. **Idle assets –** Idle assets may be in the form of unused plant, excessive cash holdings or obsolete stocks etc. The investigating accountant should ignore assets from the net worth of the business.

**Liabilities:-**

1. **Taxation:**
   - **(i)** It should be verified that adequate provision for tax has been made.
   - **(ii)** Incase there have been reopening of cases in the past, the final liability should ascertained from the order passed by the authority.
   - **(iii)** Any temporary tax benefit should be disregarded.

2. **Capital**
   - **(i)** The investigator should ascertain a proper balance between owners and debt capital. A disproportionate ratio can handicap the business.
   - **(ii)** It should be verified that the capital is reasonable as compared to fixed assets and working capital.

   The underlying purpose of conducting such an investigation is to enable the accountant in predicting with reasonable accuracy the future positioning of the business. For example, he may be able to determine the allowance required for replacement of worm out fixed assets or the turnover as over the coming period or the working capital requirements etc.

❖ **Investigation under Companies Act, 1956 *[Refer to Sec.235, 237, 239, 240, 247, etc. from Companies Act]***

❖ ***<u>Investigation for valuation of shares in private company</u>***

Networth Basis

Yield Basis

### ❖ Investigation on Behalf of Incoming Partner

The purpose of this investigation is for the incoming auditor to know whether -

**(i)** The terms offered to him are reasonable

**(ii)** His capital contribution would be safe and applied usefully.

The investigator should take care of the following -

**(i)** Ascertain the history of inception and growth of the firm.

**(ii)** Study the provisions of the partnership deed.

**(iii)** Scrutiny of the profitability and the rate o return of the firm's business over a period of time.

**(iv)** Examinations of the assets and liability position of the firm. This helps in determining the tangible asset backing, impending liabilities etc.

**(v)** Position of orders on hand the range and quality of customers should be thoroughly examined.

**(vi)** Study the composition and quality of key personnel's employed.

**(vii)** Study the important contractual and legal obligations.

**(viii)** Ascertain the reasons for offer of admission to a new partner.

**(ix)** Manner of computation of good will of admission and retirement of a partner should be ascertained.

**(x)** The standing and reliability of other partners and their personal reputation should be properly judged.

### ❖ Investigation on Behalf of Bank Proposing to Advance Loan to a Company.

A bank is primarily interested in knowing –

**(i)** the purpose for which a loan is required,

**(ii)** the sources from which it would be repaid and

**(iii)** the security that would be available to it.

The investigating accountant, should collect information on the following –

**(1)** The purpose for which the loan is required and the manner to invest the amount of the loan.

**(2)** The schedule of repayment of loan submitted by the borrower.

**(3)** The financial standing and reputation enjoyed by directors and officers of the company.

**(4)** Whether the company is authorized by the Memorandum or the Articles of Association to borrow money for the purpose for which the loan will be used.

**(5)** The history of growth and development of the company during the past 5 years.

**(6)** Effect on economic position of the company due to economic, political and social changes that are likely to take place during the period of loan.

To investigate the profitability of the business, the investigating accountant should take the under-mentioned steps –

(d) Prepare a condensed income statement from the Profit and Loss Accounts for the previous five years, showing various items of income and expenses, gross and net profits earned and taxes paid annually during each of the five years.

(e) Compute the under-mentioned ratios –

Compute the under-mentioned ratios –

(i) Sales to Average Stocks held

(ii) Sales to fixed assets.

(iii) Equity to fixed assets.

(iv) Current Assets to current liabilities.

(v) Quick assets (the current assets that are readily realizable) to quick liabilities.

(vi) Equity to long term loans.

(vii) Sales to Book debts.

(viii) Return on Capital Employed.

(f) Break-up of annual sales product-wise.

**Verification of assets and liabilities included in the financial statement submitted by the applicant:**

The investigator should prepare schedule of assets and liabilities in them the particulars given below:

1. **Fixed Assets:**
   - (i) Description of the item.
   - (ii) Gross value
   - (iii) Depreciation rate used
   - (iv) Total depreciation written off
   - (v) Nature of charge on assets created
   - (vi) Revaluation of the assets if carried out recently
   - (vii) Basis of revaluation.

2. **Inventory:**
   - **(i)** The different types of raw material and finished goods held.
   - **(ii)** Basis of valuation of the inventory.
   - **(iii)** Slow moving and obsolete items.
   - **(iv)** In case the stock has been pledged or hypothecated the fact should be stated.
   - **(v)** Assessment of the redundancy of stock consequent to changes that occurred after balance sheet.

3. **Sundry Debtors:**
   - **(i)** Composition of debtors.
   - **(ii)** Age wise classification debtors.
   - **(iii)** The adequacy of the provision if any created.
   - **(iv)** Classification as follows –
     - **a.** Debts due in respect of which the credit has not expired.
     - **b.** Debts due in respect of which the credit has expired.
     - **c.** Debts due from directors and employees.
     - **d.** Debts due from subsidiary companies or affiliated companies.
     - **e.** The subsequent recovery of debts after the Balance Sheet date.

4. **Investment:** The schedule of investment should be prepared showing date of purchase, cost, nominal value, market value and in case it is pledged for a loan, the details of people.

5. **Secured Loans:** The loans should be classified between debtor and other showing there in the secured and unsecured classification. The particulars of the assets pledged for securing the debt should be clearly stated.

6. **Provision for Taxation:** The breakup of the year wise provisions and a note on the adequacy of a each provision shall be provided.

7. **Other liabilities:** A statement to the effect that all the liabilities have been properly disclosed showing the age wise analysis of trade creditors.

8. **Insurance:** A statement of insurance policies giving details of the risk covered and the particulars of the prepayment

9. **Contingent liabilities:** A list should be provided giving a break up of the contingent liabilities existing.

Finally, the investigator should ascertain whether any other application has been made by the applicant for loans to other institutions or agencies and if so the result of such applications on the date of review.

## ❖ Procedure for investigation of frauds

1. ***Cash Receipts –*** The probability of cash being diverted before being entered in the books is very high and hence
   - **(i)** Income received from different sources should be scrutinized.
   - **(ii)** Carbon copies of receipts marked 'duplicate' should be scrutinized.
   - **(iii)** The record of small or negligible sources of income such as sales of scrap or sale of waste paper.
   - **(iv)** Recoveries from customers and sundry parties along with deductions on account of cash discounts should be reviewed and checked thoroughly.

2. ***Cash Payments –***
   - **1)** Acknowledgement for payments has to be carefully scrutinized
   - **2)** Care is required where a figure appears to have been erased on altered on such acknowledgement.
   - **3)** Payment by bearer Cheques should be checked.
   - **4)** Payment as regards wages should be examined for possible over totaling of wage sheets and entries regarding dummy workmen.
   - **5)** Check whether payment has been made in respect of supplies which have not been received.
   - **6)** Petty Cash Book itself should be vouched and totaled.

3. ***Balances in customers' ledger –*** The first steps is to find out
   - **(1)** Whether the customers are properly debited in respect of goods received.
   - **(2)** Test the entries in the order book with those in the sales daybook.
   - **(3)** Amounts adjusted on account of goods returned or difference in price as well as amounts written off as bad debts should be checked.
   - **(4)** Balance confirmations from customers.

4. ***Balances in Suppliers ledger –***
   - (1) The Bought Journal should be vouched by reference of Goods Inward Book.
   - (2) Amounts have been correctly credited in respect of goods duly received or not.
   - (3) Request the supplier to furnish statements of their accounts to find out whether or not any balance is outstanding or due and
   - (4) Confirm that allowances and rebates given by them is correctly adjusted.

5. ***Defalcation of stock –***
   - (1) The defalcation of trading stock, etc. is usually possible through a collusion among a number of persons.
   - (2) Check whether there is
     - (a) A system of stock control, and existence of detailed record of the movement of stock, or
     - (b) Availability of sufficient data from which such a record can be constructed.

(3) Physically check the quantities in stock and those shown by the stock book.

(4) Shortages observed on physical verification of stock should be reconciled with the discrepancies observed on checking the books.

❖ **Investigation for Review of Profit / Financial Forecasts *[Guidance note on Profit Forecast]***

Chartered Accountants are required to investigate into the profit forecasts of a business for various purposes like purchase of a business or sanction of loan etc. As per guidance notes issued by the ICAI a Chartered Accountant should consider the following aspects while conducting review of profit forecasts.

***1. Preliminary considerations***

(i) Obtain in writing the scope of work

(ii) Procure the following information in written from

(a) Period covered by forecast

(b) The assumptions used

(c) The purpose of forecast

(d) The ultimate user of the forecast.

***2. General considerations***

(i) Obtain a clear understanding of client's business and its environment.

(ii) Review the accounting policies.

(iii) Check the reasonableness of various assumptions.

(iv) Review the method of forecasting.

***3. Specific considerations***

**(i)** Check whether correct accounting policies have been consistently applied over the period of forecast.

**(ii)** Ensure proper disclosure of extra ordinary items.

**(iii)** Incase where purpose of forecast is to estimate fund requirements, ensure that proper bifurcation has been made between working capital and long term capital requirements.

**(iv)** Proper investigation into the current status of the entity should be made.

**(v)** Evaluate the opinion of other exports.

**(vi)** Ensure the proper explanatory notes supplement the forecasts.

**(vii)** The investigator should properly adjust inflationary factors and make reasonable inter firm comparisons.

The report of the investigator should cover the following aspects.

**(i)** The assumptions used

**(ii)** The forecasts made

**(iii)** Conclusions of the review.

## DUE DILIGENCE

**(1)** This term is used is relation to corporate restructuring.

**(2)** Corporate restructuring includes internal reconstruction, amalgamations, mergers, joint ventures etc.

**(3)** Corporate restructuring involving ***more than one party*** should be ***planned*** properly.

**(4)** Thus, due diligence ***review*** is performed to check whether it is ***feasible and desirable*** to acquire / merge the unit.

**(5)** Discipline-wise it can be classified as follows:

- **(a) Commercial /operation 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 financial statement 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 are the tax benefits available to target.
- **(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 the target is complying with all the applicable laws and 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 efficient.

## FINANCIAL DUE DILIGENCE

Sometimes it is interpreted as complete Due Diligence review as it ascertain the ***financial implications*** of all other Due diligence reviews, yet its scope is less than over all Due Diligence reviews.

A full-fledged financial Due Diligence review includes the following:-

**(1) BRIEF HISTORY OF TARGET AND BACKGROUND OF ITS PROMOTERS:-**

How Company was set up, who were original promoters, its survival strategies in past, any regulatory requirement, history like nature of production, location, product/ service and markets, franchises, licenses, patents, R & D, legislation & regulation, information systems.

**(2) ACCOUNTING POLICIES:-**

Appropriateness, effect of recent changes in A/c policies, effect on overall profitability and their correctness. Areas where A/c polices of target are different from that of acquiring enterprise and their effect.

**(3) Review of Financial Statement:-**

In accordance with statute, relevant framework and A/c standards. Review the operating results, extraordinary items. Comparison of actual figures with budgeted figure. Trading results of last 4-5 years, valuation of intangible assets, special attention to over valued assets or hidden liabilities.

**(4) Taxation:-**

Regularity of payment of various taxes to government, tax affects of mergers.

**(5) Cash Flow:-**

Cash generating abilities and major trends.

**(6) Financial Projections:-**

For next ***5 yrs*** with detailed ***assumption***s and workings on optimistic, pessimistic and most likely basis. If projections are inappropriate highlight the areas.

**(7) Management and Employees:-**

Status of work force, staff and their demands etc. excess work force and implications, pay package, employee benefit PF, gratuity, E.S.I. leave and superannuation etc. to be taken care of.

**(8) Statutory compliance:-**

List of applicable laws, punitive charges etc.

**Fine/Penalty-**

**<u>Contents of Due Diligence Report</u>**

**(i)** Summary
**(ii)** History of Target
**(iii)** History of Promoters
**(iv)** Review of Operational D.D
**(v)** Review of Financial D.D
**(vi)** Review of Tax D.D
**(vii)** Review of Information system D.D
**(viii)** Review of Legal D.D
**(ix)** Review of Environmental D.D
**(x)** Review of Personnel D.D
**(xi)** SWOT Analysis
**(xii)** Suggestion

# TAX AUDIT

Under I.T. Act, audit is to be conducted by an Accountant. It defines accountant as ***a C.A.*** within meaning of C.A. Act & any other person entitled to be appointed as an auditor of a company u/s 226 of Company Act. But as per C.A. Act, it will nevertheless a necessary requirement that the member concerned must hold a certificate of practice.

But for Co. op. societies, the auditor appointed under the relevant statute provision need not be a C.A. but he can conduct the tax audit.

**Audit of Public trusts (Sec. 12A)**
Exemption from I.T. u/s 11 & 12 provided :

1. 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.
2. Where total income > 50,000 in any previous year, the accounts of trust/ Institute have been audited.
   - ⇨ As per guide published by ICAI, the audit programme in this case will be as follows :

(A) **Preliminary**
- (i) Obtain ***resolution*** from trust (Scope of audit)
- (ii) Letter of appointment from trust & communicate with previous auditor.
- (iii) Certificate as to op. balance of Assets & Liabilities & fund
- (iv) List of Books of A/c
- (v) Certificate from trust as to system of A/c & I.C.
- (vi) List of institutions/ activities run by trust
- (vii) Certified true copy of deed of trust.

(B) **Routine checking**
- (i) Check Book of A/c.
- (ii) Vouch transactions. Whether within power and authorised, Properly A/c for, recorded on the basis of system of Accounting etc & funds applicable towards objects of the trust.
- (iii) Obtain trial Balance on closing date certified by trust.
- (iv) Obtain B/s & P & L A/c authenticated by trustee.

(C) **A/c Principles:** Usually accepted A/c Principles. In Particular.
- (i) All assets verified properly valued & depreciated.
- (ii) All liabilities properly A/c for.
- (iii) Investment properly classified & market values shown.
- (iv) O/s due to trust properly A/c for. Its recoverability examined. Provided made for irrecoverable.

(D) **Annexure to Audit Report:-**
- (i) Certified list of persons u/s 13(3).
- (ii) Statement for items specified in annexure to form 10B.
- (iii) Verify information supplied by trustees in light of available mater.

**Audit u/s 44AB**
Any person get his A/c audited by an Accountant who:
- (i) Carrying on Business, total turnover or gross receipt > 40 lakh Rs.
- (ii) Carrying on Profession, if gross receipt > 10 lakh Rs.
- (iii) Carrying on Business if profits & gains from Business are deemed to be profits & gains of such person if he has claimed has income to be lower than deemed one.

⇨ Audit by specified date i.e. 31st October.

**Applicability of A/c Standards**
In case of charitable / religious organisations, AS will ***not*** apply if ***all*** activities are not of commercial, industrial or business nature. Even if a small portion of activates of an entry is commercial, industrial

or Business in nature, AS would apply to all its activates including those which are not commercial, industrial or Business in nature.

**Section 145:-**

(i) Income under head ***"Business or profession'*** or ***from other sources'*** be computed in accordance with either cash or mercantile regularly employed by the assessee.
(ii) C.G. may notify AS to be followed
(iii) If A.O. not satisfied about correctness or completeness of A/c of Assessee or where method, of a/c followed have not been regularly followed by the assessee, he may make assessment AS per method Provided u/s 144.

As (I.T.) Mandatory for those following ***mercantile*** system.

(i) AS I relating to disclosure of A/c policies
(ii) AS II relating to disclosure of prior period & extraordinary items & changes in A/c Policies.

The tax auditor is not computing the income but

(i) reporting on A/c &
(ii) reporting on relevant information furnished in form no. 3CD. Thus in case of non-compliance with AS, the C.A should make appropriate qualification/ disclosure in the audit report.

**<u>Audit Report:-</u>**

(i) Form 3CA + 3CD for person carrying on Business or profession who is required under any other law to get his A/c audited &
(ii) For 3CB + 3CD for others.

**FORM NO. 3CD**

[See rule 6G(2)]

**Statement of particulars required to be furnished under Section 44AB of the Income-Tax Act, 1961**

## PART A

| | | | |
|---|---|---|---|
| **1.** | Name of the assessee | : | ______________________ |
| **2.** | Address | : | ______________________ |
| **3.** | Permanent Account Number | : | ______________________ |
| **4.** | Status | : | ______________________ |
| **5.** | Previous year ended | : | ___31$^{st}$ March___________________ |
| **6.** | Assessment year | : | ______________________ |

**PART B**

**7.** (a) If firm or Association of Persons, indicate names of partners/members and their profit sharing ratios.

(b) If there is any change in the partners/members of their profit sharing rations, the particulars of such change.

**8.** (a) Nature of business or profession.

(b) If there is any change in the nature of business or profession, the particulars of such change.

**9.** (a) Whether books of account are prescribed under section 44AA, if yes, list of books so prescribed.

(b) Books of account maintained. (In case books of account are maintained in a computer system, mention the books of account generated by such computer system.)

(c) List of books of account examined.

**10**. Whether the profit and loss account includes any profits and gains assessable on presumptive basis, if yes, indicate the amount and the relevant sections (44AD, 44AE, 44AF, 44B, 44BB, 44BBA, 44BBB or any other relevant section).

**11**. (a) Method of account employed in the previous year.

(b) Whether there has been any change in the method of Accounting employed *vis-à-vis* the method employed in the immediately preceding previous year.

(c) If answer to (b) above is in the affirmative, give details of such change, and the effect thereof on the profit or loss.

(d) Details of deviation, if any, in the method of accounting employed in the previous year from accounting standards prescribed under section 145 and the effect thereof on the profit or loss.

**12**. (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 the profit or loss.

**13**. Amounts not credited to the profit and loss account, being, –

(a) The items falling within the scope of section 28;

(b) The proforma credits, drawbacks, refunds of duty of customs or excise, or refunds of sales tax, where such credits, drawbacks or refunds are admitted as due by the authorities concerned;

(c) Escalation claims accepted during the previous year;

(d) Any other item of income;

(e) Capital receipt, if any.

**14**. Particulars of depreciation allowable as per the Income-Tax Act, 1961 in respect of each asset or block of assets, as the case may be, in the following form:–

(a) Description of asset/block of assets.

(b) Rate of depreciation.

(c) Actual cost or written down value, as the case may be.

(d) Additions/deductions during the year with dates; in the case of any addition of an asset, date put to use; including adjustments on account of –

(i) Modified Value Added Tax credit claimed and allowed under the Central Excise Rules, 1944, in respect of assets acquired on or after 1st March, 1994,

(ii) Change in rate of exchange of currency, and

(iii) Subsidy or grant or reimbursement, by whatever name called.

**15**. Amounts admissible under sections 33AB, 33ABA, 33AC, 35, 35ABB, 35AC, 35CCA, 35CCB, 35D, 35E:–

(a) Debited to the profit and loss account (showing the amount debited and deduction allowable under each section separately);

(b) Not debited to the profit and loss account.

**16**. (a) Any sum paid to an employee as bonus or commission for services rendered, where such sum was otherwise payable to him as profits or dividend. [Section 36 (1) (*ii*)].

(b) Any sum received from employees towards contributions to any provident fund or superannuation fund or any other fund mentioned in section 2(24)(*x*); and due date for payment and the actual date of payment to the concerned authorities under section 36(1)(*va*).

**17**. Amounts debited to the profit and loss account, being:–

(a) Expenditure of capital nature;

(b) Expenditure of personal nature;

(c) Expenditure on advertisement in any souvenir, brochure, tract, pamphlet or the like, published by a political party;

(d) Expenditure incurred at clubs:–
   (i) As entrance fees and subscriptions;
   (ii) As cost for club services and facilities used;

(e) (i) Expenditure by way of penalty or fine for violation of any law for the time being in force.
   (ii) Any other penalty or fine.
   (iii) Expenditure incurred for any purpose which is an offence or which is prohibited by law;

(f) Amounts inadmissible under section 40(a);

(g) Interest, salary, bonus, commission or remuneration inadmissible under section 40(b)/40(ba) and computation thereof;

(h) Amount inadmissible under section 40A(3) read with rule 6DD and computation thereof;

(i) Provision for payment of gratuity not allowable under section 40A(7);

(j) Any sum paid by the assessee as an employer not allowable under section 40A(9);

(k) Particulars of any liability of a contingent nature.

**18**. Particulars of payments made to persons specified under section 40A(2)*(b*).

**19**. Amounts deemed to be profits and gains under section 33AB or 33ABA or 33AC.

**20**. Any amount of profit chargeable to tax under section 41 and computation thereof.

**21**. * (i) In respect of any sum referred to in clause *(a*), (*c*), (*d*), or (*e*) of section 43B, the liability for which:–

A. Pre-existed on the first day of the previous year but was not allowed in the assessment of any preceding previous year and was –
   (a) paid during the previous year;
   (b) not paid during the previous year;

B. Was incurred in the previous year and was –
   (a) paid on or before the due date for furnishing the return of income of the previous year under section 139(1);
   (b) not paid on or before the aforesaid date.

(ii) In respect of any sum referred to in clause *(b)* of section 43B, the liability for which –

A. Pre-existed on the first day of the previous year but was not allowed in the assessment of any preceding pervious year –
   (a) nature of liability;
   (b) due date of payment under second proviso to section 43B;
   (c) actual date of payment;
   (d) if paid otherwise than in cash, whether the sum has been realised within fifteen days of the aforesaid due date:

B. Was incurred in the previous year:–
   (a) nature of liability;
   (b) due date of payment under second proviso to section 43B;
   (c) actual date of payment;
   (d) if paid otherwise than in cash, whether the sum has been realised within fifteen days of the aforesaid due date.

* State whether sales tax, customs duty, excise duty or any other indirect tax, levy, cess, impost, etc., is passed through the profit and loss account.

**22**. (a) Amount of Modified Value Added Tax credits availed of or utilized during the previous year and its treatment in the profit and loss account and treatment of outstanding Modified Value Added Tax credits in the accounts.

(b) Particulars of income or expenditure of prior period credited or debited to the profit and loss account.

**23**. Details of any amount borrowed on hundi or any amount due thereof (including interest on the amount borrowed) repaid, otherwise than through an account payee cheque [Section 69D].

**24**. (a) * Particulars of each loan or deposit in an amount exceeding the limit specified in section 269SS taken or accepted during the previous year:–

(i) name, address and permanent account number (if available with the assessee) of the lender or depositor;

(ii) amount of loan or deposit taken or accepted;

(iii) whether the loan or deposit was squared up during the previous year;

(iv) maximum amount outstanding in the account at any time during the previous year;

(v) whether the loan or deposit was taken or accepted otherwise than by an account payee cheque or an account payee bank draft.

* (These particulars need not be given in the case of a Government company, a banking company or a corporation established by a Central, State or Provincial Act.)

(b) Particulars of each repayment of loan or deposit in an amount exceeding the limit specified in section 269T made during the previous year:–

(i) name, address and permanent account number (if available with the assessee) of the payee;

(ii) amount of the repayment;

(iii) maximum amount outstanding in the account at any time during the previous year;

(iv) whether the repayment was made otherwise than by account payee cheque or account payee bank draft

**25.** Details of brought forward loss or depreciation allowance, in the following manner, to the extent available:

| *Serial Number* | *Assessment Year* | *Nature of loss/allowance (in rupees)* | *Amount as returned (in rupees)* | *Amount as assessed (give reference to relevant order)* | *Remarks* |
|---|---|---|---|---|---|
| | | | | | |

**26.** Section-wise details of deductions, if any, admissible under Chapter VIA.

**27.** (a) Whether the assessee has deducted tax at source and paid the amount so deducted to the credit of the Central Government in accordance with the provisions of Chapter XVII-B.

(b) If the answer to (a) above is in negative, then given the following details:

| *Serial Number* | *Particulars of head under which* | *Amount of tax deducted at* | *Due date for remittance to* | *Details of payment:* | *Remarks* |
|---|---|---|---|---|---|

| | *tax is deducted at source* | *source (in rupees)* | *Government* | *Date/Amount (in rupees)* |
|---|---|---|---|---|
| | | | | |

**28.** (a) In the case of trading concern, given quantitative details of principal items of goods traded:
(i) opening stock;
(ii) purchases during the previous year;
(iii) sales during the previous year;
(iv) closing stock;
(v) shortage/excess, if any.

(b) In the case of manufacturing concern, give quantitative details of the principal items of raw materials, finished products and by-products:

A. Raw materials
(i) opening stock.
(ii) purchases during the previous year;
(iii) consumption during the pervious year;
(iv) sales during the previous year;
(v) closing stock;
(vi) * yield of finished products;
(vii) * percentage of yield;
(viii) * shortage/excess, if any.

B. Finished products/By products
(i) opening stock;
(ii) purchases during the pervious year;
(iii) quantity manufacturing during the previous year;
(iv) sales during the previous year;
(v) closing stock;
(vi) shortage/excess, if any.

* Information may be given to the extent available.

**29.** In the case of a domestic company, details of tax on distributed profits under section 115-O in the following form:–
(a) total amount of distributed profits;
(b) total tax paid thereon;
(c) dates of payment with amounts.

**30.** Whether any cost audit was carried out, if yes, enclose a copy of the report of such audit [See section 139(9)].

**31.** Whether any audit was conducted under the Central Excise Act, 1944, if yes, enclose a copy of the report of such audit.

**32.** Accounting ratios with calculations as follows:–
(a) Gross profit/Turnover;
(b) Net profit/Turnover;
(c) Stock-in-trade/Turnover;
(d) Material consumed/Finished goods produced.

Signed: ____________

*Place* ____________ Name: ____________

*Date* _____________                                                                                                    Address:

______________________

**Notes:**

1. *The Annexure to this Form must be filled up falling which the Form will be considered as incomplete.*
2. *This Form and the Annexure have to be signed by the person competent to sign Form No. 3CA or Form No. 3CB, as the case may be.*

**Annexure**

**PART A**

**1.** Name of the Assessee : ________________________

**2.** Address : ________________________

**3.** Permanent Account Number : ________________________

**4.** Status : ________________________

**5.** Previous year ended : ________________________

**6.** Assessment year : 31st March ________________________

________________________

**PART B**

| Name of Business | Code* | | | | |
|---|---|---|---|---|---|

| **Sl. No.** | **Parameters** | **Current year** | **Preceding year** |
|---|---|---|---|
| **1.** | Paid-up share capital | | |
| **2.** | Share Application Money | | |
| **3.** | Reserves and Surplus | | |
| **4.** | Secured loans | | |
| **5.** | Unsecured loans | | |
| **6.** | Current liabilities and provisions | | |
| **7.** | Total of Balance Sheet | | |
| **8.** | Gross turnover | | |
| **9.** | Gross profit | | |
| **10.** | Commission received | | |
| **11.** | Commission paid | | |
| **12.** | Interest received | | |
| **13.** | Interest paid | | |
| **14.** | Depreciation as per books of account | | |
| **15.** | Net Profit (or loss) before tax | | |
| **16.** | Taxes on income paid/provided for in the books | | |

Signed: _______________

*Place* _________________

*Date* _________________

**Note:**

- Please enter the relevant code pertaining to the main area of your business activity.

# EDP – AUDIT

1. **Current IT Trends :**
   - **(i)** End user computing
   - **(ii)** Declining Hardware prices, increase in micro user
   - **(iii)** RDBM extensive use
   - **(iv)** System development and CASE tools adopted by many users..
   - **(v)** Shift from DOS to UNIX & C language.
   - **(vi)** Knowledge based and decision support systems.
   - **(vii)** Increased data communication and networking
   - **(viii)** Use of EDI (Electronic data interchange)
   - **(ix)** Scanners and voice recognition system for input.
2. **Impact on Auditing :**
   - **(i)** Unintentional Errors (inexperienced persons)
   - **(ii)** Program modification can take place with a view to fraud.
   - **(iii)** Improper use of DSS.
   - **(iv)** Auditors participation in SDLC is necessary.
   - **(v)** Use of sophisticated audit software.
   - **(vi)** Data communication and networking – new risk.
   - **(vii)** Data security problems.
   - **(viii)** Move towards EDI (Elimination of much of traditional audit trail).
   - **(ix)** Change in nature of audit evidence.

***TYPES OF EDP ACCOUNT SYSTEMS***

| ***Batch Processing*** | ***Processing systems*** *OLRT System* | ***Time Sh. & Service Buseu*** |
|---|---|---|
| *Batch (group) of transaction, tr. File, master file, batch totals, simple rarely found* | *Ready updation inquiry processing complex, no audit trail.* | *TS – one computer and more than one use. S.B. – an entity processing for others.* |

***File Systems***

| ***Flat File Systems*** | ***Integrated data base systems*** |
|---|---|
| *User own their data, data redundancy. For same transaction, updation to be made at many place.* | *Set of inter related master file, easy updation, data warehousing, immense volume, cross indexing.* |

**<u>EDP Organization Structure</u>**

1. EDP Manager.
2. System analyst.
3. Programmers
4. Computer Operators.
5. Input Preparation Group.

6. Librarian.
7. Data Control Group.

**Prerequisites auditing in CIS Environment.**

1. ***Skill & Competence :***To determine over all audit risk, understanding I.C. to perform tests and to evaluate results thereof.
2. ***Knowledge of Business :*** Entity's attitude towards I.T., usage compared with industry, recent and planned charges.
3. ***Planning :*** To plan understanding about organization structure, significance of comp. Processing, complexity, availability of data source documents, files, etc.
4. ***Assessment of Risk :*** Risk may be due to deficiencies in CIS environment and they may increase potential for errors of fraudulent activities.

He should consider the following for risk assessment

1. Own application / packages.
2. Industrial environment.
3. Pervasive CIS controls.
4. Access to sp. function / data.
5. Ability to change and develop the report.
6. Documentation.
7. Factors affecting quality of evidence (paperless).
8. Sp. risk (Electronic funds trf.).
9. End-user computing.
10. Lack of time, discipline or knowledge to monitor results of processing.

**Compensating for loss of audit trail :**

1. Arranging for sp. print-outs of additional informal.
2. Programmed interrogation facility.
3. Clerical recreation.
4. Testing on total basis.
5. Relying on alternative tests.
6. Special Audit Technique.

**INTERNAL CONTROLS IN COMPUTER BASED SYSTEM**

These controls include both manual procedures and procedures designed into the computer system. The controls can be broadly classified into general controls and application controls.

**IT General Controls**

General controls relate to the environment within which computer based accounting systems are developed, maintained and operated. They apply to all individual applications. General IT controls include:

1. **Organization and management controls**

   These controls provide organizational framework to IT activities.

2. **Application system development and maintenance controls**

   Designed to provide reasonable assurance that systems are developed and maintained in an efficient and authorized manner.

3. **Computer operation controls**

   These controls ensure that authorized persons only who perform authorized programs and that all errors are prevented and detected by the systems access the system.

4. **System software controls**

These controls are designed to ensure that acquisition and development of system software is properly authorized and documented.

5. **Data Entry and programs controls**

   These controls provide reasonable assurance that all transactions are properly authorized and access to data and programs are to restricted persons.

**IT application controls**

Application controls are controls over the thoroughness, accuracy and validity of accounting information. These controls include:

1. **Controls over inputs**

   These controls are designed to provide reasonable assurance that,

   **(a)** All transactions are authorized.

   **(b)** Transactions are not lost or improperly added or modified.

   **(c)** The system detects and reports incorrect transactions.

2. **Controls over processing and computer data files**

   The objective of these controls is to provide assurance that,

   **(a)** All transactions are properly processed.

   **(b)** Processing errors are identified and corrected on a timely basis.

3. **Controls over output**

   These controls are designed to provide the accurate outputs are timely provided to authorised persons.

**Computer Assisted Audit Techniques (CAAT) (Used in Auditing through the computer)**

1. **Audit Software:** It is a set of computer programs used by the Auditor, as part of his Auditing Procedures, to process data of audit significance from the entity's accounting system. The Auditor should use such programs only after he proves their validity for Audit purposes. Audit Software may consist of:

   (a) **Package Programs –** These are generalised Computer Programs, that perform data processing like reading computer files, selecting information, performing calculations, creating data files and printing reports in a format specified by the Auditor. May be used at many clients site.

   (b) **Purpose Written Programs –** These are Computer Programs, designed by the Auditor / entity / outside programmer, to perform Audit tasks in specific circumstances. The Auditor may sometimes use the programs of the entity in the same or in a modified form. But it may not be used at many clients site thus cost consideration should taken care of.

   (c) **Utility Programs –** These are programs of the entity, designed for non-audit purposes, but for performing common data processing functions like sorting, creating and printing files. These are not designed specifically for audit purpose.

   (d) **System management software –** These are enhanced productivity tool that require specialised knowledge on part of auditor. However these are not specifically meant for audit purposes. Thus used with much skill and care. For example flow chart review systems. It may be used for comparing source code with object code.

2. **Test Data:** The Auditor enters a set of test data into the entity's computer system and compares the results with predetermined results. Test data are used to test specific controls / specific processing characteristics in computer programs like online password and data access controls. The test data are chosen by the Auditor. They may be of the following types –

   (a) Testing a set of data selected from **previously processed transactions,** in the entity's system, ***separately*** from the normal processing procedure.

(b) Establishing a **dummy unit** to which test transactions are posted ***during*** the normal processing cycle of the entity. (Called integrated Test Facility). However, the dummy entries should subsequently be eliminated from the entity's accounting records. These are used mainly on line real time systems.

**USE OF CAAT**

CAAT are used to perform various Audit Procedures like –

1. **Tests of Details** of transactions and balances e.g. use of Audit software to test all / few transactions in a computer file. As substantive procedures.
2. **Analytical Review Procedures** e.g. use of Audit software to identify unusual fluctuations or unusual items.
3. **Compliance Test of General IT Controls** e.g. use of test data to test access procedures to the program libraries.
4. **Compliance Test of IT Application Controls** e.g. use of test data to test the functioning of a programmed procedure.

**Use of CAAT / Audit Software Systems in Fraud Detection:**

1. Even while auditing in an EDP environment, the Auditor is required to plan his work by exercising reasonable care and skill in such a manner that there is reasonable expectation of detecting material misstatements in the financial information resulting from fraud or error.
2. Use of the above CAAT / audit software systems will help the Auditor to identify errors and frauds in the accounting and internal control system.
3. However, frauds are intentional and generally deep-laid. While auditing through the computer with adequate knowledge of computer systems may highlight some frauds, there is not empirical evidence to prove the assertion that the use of audit software systems has unearthed well-concealed frauds. Thus it cannot be conclusively said that use of audit software systems increases the probability of detection of fraud due to inherent limitation present in any audit.

**Consideration in use of CAATs**

1. Computer knowledge, expertise and experience of the auditor.
2. Availability of CAATs and suitable computer facilities.
3. Impracticability of manual tests.
4. Effectiveness and efficiency.
5. Timing.

**Steps in application of CAATs**

1. Setting objective of CAAT.
2. Content and accessibility of entity's files.
3. Tr. type to be tested.
4. Procedure to be performed on data.
5. Define output req.
6. Personnel.
7. Refine cost and benefit estimates.
8. Ensure documentation of CAAT use.
9. Arrange administrative activities.
10. Execute CAAT application.
11. Evaluate the results.

**The Auditor should take the following measures to control CAAT applications**

| Control of Software Applications | Control of Test Data |
|---|---|
| • Participate in the design and testing of the computer programmes.<br>• Check the coding of program to ensure conformity with detailed program specifications.<br>• Review of operating system instructions to ensure proper running of software in the entity's computer application.<br>• Run audit software first on test files before taking up the same on main data files.<br>• Ensure use of correct files.<br>• Obtain evidence as too implementation of audit software as planned.<br>• Establishment security measures to safeguard manipulation of data files & his audit software.<br>• He should arrange for proper vendor support. | • Control the sequence of submission of test data.<br>• Perform test runs containing small amounts of test data before submitting main audit test data.<br>• Predict the results of test data and compare with actual test data output, both for individual transactions and also in total.<br>• Confirm that only current version are used to process test data.<br>• Obtain reasonable assurance regarding the continued use of programs throughout the period of audit. |

❖ **Documentation :** about planning, execution audit evidence, etc.

❖ **CAATs in small business comp. Environment :**

**(i)** Less reliance on I.C. thus, greater emphases on tests of details and application of audit procedures.

**(ii)** If small volume of data – manual methods.

**(iii)** Impracticable use of CAAT due to absence of technical assistance.

**(iv)** Few program may not run on small computers.

**(v)** Thus it may not be practicable to use CAAT in small business environment in all cases.

❖ **Auditors involvement in computerization.**

*Planning Topic*

**(1)** Comp. First time – feasibility study.

**(2)** Hardware / Software specification.

**(3)** Physical planning and site preparation.

**(4)** Organization structure.

**(5)** Corporate computerization plan.

**(6)** Project plan for every application.

**(7)** DRP (Disaster recovery plan).

*Execution*

**(1)** Understanding user requirements.

**(2)** Limitation and scope of standard packages.

**(3)** Proper training of staff at all levels.

**(4)** Organization must be service oriented.

**(5)** Flexibility.

<u>**Requirement for internal auditor**</u>

- **Requirements for comp. Audit program system :**

| | | |
|---|---|---|
| **(i)** Simplicity | **(ii)** Understandability | **(iii)** Adaptability |
| **(iv)** Vendor technical support | **(v)** Statisticals sampling tech. | **(vi)** Acceptability |
| **(vii)** Processing capabilities | **(viii)** Report writing | |

- ***Applications***

| | | |
|---|---|---|
| **1.** Inventories | **2.** Payrolls | **3.** Maintenance |
| **4.** Energy | **5.** Travel & Telephone | **6.** Sales |

# SERVICE BUREAU

*Consideration of following mattes with client :*

1. **Ownership and stability :** Share holders, cr. rating, other clients, commercial appropriate staff.
2. **Location :** Conditions (geographical and others) machine loading (high or low).
3. **Back up :** Stand by arrangements.
4. **Documentation education and programs, etc.** : Systems and program documentation manual, staff training, approved changes, authorized owner of copyrights of programs ownership of data files.
5. **Liability of bureau for :** Losses to lateness, fraud, confidentiality, corruption of megnatic media.
6. **Control :** Over data processed, reconciliation, amendments and error reports, file retention.
7. **Packages :** Standard software package, req. of input and format and output.

❖ **Audit consideration of comp. Bureau.**

*Movement of data outside client's premises, data preparation. Following matters should be considered :*

- **(i)** Liaison between user and bureau.
- **(ii)** Systems testing.
- **(iii)** Responsibility for file conversion.
- **(iv)** Responsibility for rejection.
- **(v)** Output procedures defined.
- **(vi)** Control over maintenance of master file.

**Tagging and Tracing**

1. It is used for compensating loss of audit trail.
2. It involves tagging the clients input data in such a way that relevant information is displayed at key points to be verified by the auditor.
3. The hard copy generated is made available only to the auditor. For e.g. sales order in excess of 10 lakh etc.
4. It uses actual data, thus question of elimination of special entries (as in integrated test data facility) does not arise at all.
5. However, all erroneous data may not necessarily be tagged.
6. Auditor uses his professional judgment to decide the key point.

**Effect of P.C environment on Audit Procedure**

- **(i)** Not practicable to implement suff. Internal controls. This control risk is high.
- **(ii)** No need for compliance procedure. He may directly switch over to substantive procedure.
- **(iii)** He may use CAAT's (Audit Software)
- **(iv)** He may perform audit work on a preliminary data (surprise visits)
- **(v)** Specific internal control characteristics.

**Effect of on line system on Audit Procedure**

- **(i)** Less Audit trail
- **(ii)** Authorisation & accuracy of on line transaction must be checked.
- **(iii)** He should include technical persons in Audit team.
- **(iv)** He should perform compliance preliminary if the preliminary assesses control risk as less than high.
- **(v)** Sub procedure should include CAAT (normally ITF).

**(vi)** Auditor should carry out Pre-implementation review of OLRT system if possible.

**Note:**
On data base I.C w.r.t. access the Date Base must be properly securitinised.

# Audit of Public Sector Undertaking

## OBJECTIVES OF AUDIT OF PSU

→ In PSU, there is involvement of public fund.
→ These funds should be utilized considering public interest.
→ Normally, these funds are lavishly used by management.
→ 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)
→ Thus the main objective of auditor in such case is to check the substance of transaction entered into by the PSU.
→ Auditor has to check whether transactions mainly expenses confirmed to propriety norms.

## PROPRIETY AUDIT

→ "Propriety Audit stands for verification of transactions on the test of *public interest*, commonly accepted *customs & standards* of conduct".

→ 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. Kohler.

→ It shifts the emphasis to *substance of transaction.*

→ It requires transactions (mainly expenses) to conform to certain general principles :

**a)** 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.
**b)** *Authority* exercises its *power* of sanctioning expenses to pass an order which will not accrue to its own advantage.
**c)** Funds *not* utilized for *benefit* of a particular person/group.
**d)** Apart from *agreed remuneration*, no other avenue is kept open to benefit management personnel, employees and others.

**PROPRIETY ELMENT 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.

**PROPRIETY ELEMENT UNDER COST AUDIT REPORT :**

**b)** Matters appearing clearly wrong in principle or apparently wrong.
**c)** Cases where company's funds have been used in negligent/inefficient manner.
**d)** Factors which could have been controlled but haven't been, thus, resulting in increase in cost of production.

**PROPERTY ELEMENTS IN CARO, 2003**

**a)** If the company has given or taken loans, secured or unsecured, to/from companies, firms or other parties listed in the register maintained under section 301 of the Companies Act, whether the rate of interest and other terms and conditions of such loans are prima-facie prejudicial to the interest of the company. In this case, the auditor will have to look into the reasonableness of the rate of interest and the terms and conditions of such loans. In other words, he will have to see whether the terms and conditions, including the rate of interest are apparently adverse to the interests of the company, having regard to the circumstances of the company at the time of taking the loans and the terms normally available. He is to exercise his judgment based on commercial considerations like urgency, security offered etc.

**b)** If the overdue amount of the loan given to or taken from companies, firms or other parties listed in the register maintained under section 301 of the Companies Act is more than rupees one lakh, what reasonable steps have been taken by the company for recovery/payment of the principal and interest. In making this examination, the auditor would have to consider the facts and circumstances of each case, including the amounts involved. It is not necessary that steps to be taken must necessarily be legal steps. Depending upon the circumstances, period of delay and other similar factors, issue of reminders or sending of advocate's or solicitor's notice may amount to reasonable steps. The auditor should ask the management to give in writing the steps which have been taken. The auditor should arrive at his opinion only after consideration of the management's representations.

**c)** Whether the transactions needed to be entered in a register in pursuance of section 301 of Companies Act have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time. Section 301 requires that every company shall keep one or more registers in which shall be entered separately the particulars of all contracts or arrangements to which sections 297 and 299 of the Companies Act apply. As regards the reasonability of prices, the auditor is not expected to make a roving market inquiry but to examine price lists, quotations, prices for other parties etc. he should also taken into account the factors such as delivery period, quality, quantity involved, credit terms etc.

**d)** Is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employee State Insurance, Income-Tax, Sales Tax, Wealth Tax, Custom Duty, Excise Duty, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the dat they became payable, shall be indicated by the auditor.

**e)** Whether the company has made any preferential allotment of shares to parties and companies covered in the register maintained under section 301 of the Companies Act and if so whether the price at which shares have been issued is prejudicial to the interest of the company.

**PROPRIETY AUDIT- PROBLEMS**

→ It is a moral term.
→ Auditing requires verifiable propositions establishment of which is very difficult for propriety audit.
→ It has itinerant element of subjectivity.
→ However, C and AG has developed norms of propriety for expenses of public funds but it may not apply to transactions of private sector.
→ If management formulates norms of propriety for the entity, the element of subjectivity will get reduced.
→ For e.g. – Travel by air (*feasible if saves time*).
→ The judgement of auditor shouldn't be subjective.

**COMMITTEES ON PUBIC UNDERTAKINGS**

→ It examine the Audit report.
→ It can select some enterprises each year to examine whether affairs of same are managed in accordance with sound business principles, *etc.*
→ It *doesn't* however examine mattes of major Government policy or day-to-day administration.

→ It gives its findings and recommendations in its report which are presented to Parliament / State Legislatures.

**Types of Audits**

***(1) Professional*** ***(2) Supplementary Audit u/s. 619(4)***

**Supplement Audit**

→ C & AG may comment upon or supplement the report submitted by the professional auditor.

→ C & AG may issue directives to the auditors in regard to the performance of their function.

→ Person so authorised may well be the auditor of the company.

→ The form & content of supplementary audit report may be specified by C&AG.

→ Supp Auditor may concentrate more on efficiency aspects.

→ The person so authorised is having same powers as auditors.

**COMPREHENSIVE AUDIT**

Scope is regarding checking of investment decisions, Project formulation, MIS, Capacity utilisation, Management, Use of material, Labour, Idle capacity, Capital cost, Cost control measure, R & D programs, Repair & maintenance etc.

**Directions of C & AG :**

(a) **System of Account :**

1. Examine the following systems and give deficiencies along with suggestions (Receipts/Expenses/Trial Balance/Inventories, etc.)
2. Allocation of expenses during construction.
3. Bank Reconciliation Statement.
4. Control and subsidiaries account are updated and reconciled regularly.
5. Examine accounting policies.

(b) **System of Financial Control :**

1. Delegation of financial power whether legally made.
2. Whether credit from bank are monitored regularly.

# BANK AUDIT

There are mainly 4 types of Banks :

(1) Commercial Bank
(2) Regional Rural Bank
(3) Co-operative Banks
(4) Development Bank.

**Special Features of Banks :**

1. Custody of Large Volume of Monetary Item.
2. Large Volume and Variety of Transactions.
3. Wide Network of Branches and Departments.
4. Off-Balance Sheet items (no entry like guarantees etc.)
5. Regulated by Government authorities.

**FORM & CONTENT OF FINANCIAL STATEMENT [Vertical form)**

→ **Capital and Liabilities** (5 heads)
- Capital
- Reserve and Surplus
- Deposits
- Borrowings
- Other liabilities and provision

→ **Assets** (6 heads)
- Cash and Balance with RBI
- Balance with Banks and money at call and short notice.
- Investment
- Advances
- Fixed Assets
- Other assets

→ Contingent Liabilities and Bills for collection (aggregate amount to be shown on face of Balance sheet and details by way of a note.

→ **ON FACE OF PROFIT AND LOSS ACCOUNT**

1. **Income** - Interest Earned
   - Other Income
2. **Expenditure** - Interest expended
   - Operating expenses
   - Provision and Contingencies
3. **Profit / Loss** - Net profit (loss) for the year
   - Profit / Loss brought forward
4. **Appropriations** - Transfer to Statutory Reserve
   - Transfer to other Reserves
   - Transfer to Government / Proposed Dividend
   - Balance carried over to Balance Sheet.

→ **Signature :** Financial statements 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.

→ **Appointment of Auditor :** Appointment of Auditor of Banking Company to be appointed at AGM of shareholders wherein fee is also determined. (Approval of RBI regarding appointment). Appointment of Auditor of Nationalised Bank by Bank concerned acting through its BOD (approval of RBI) their fee determined by RBI in consultation with Central Government.

Auditor of subsidiaries of SBI as well as their remuneration is decided by SBI.

Auditor of SBI and their remuneration by RBI in consultation with Government Bank.

RRB's auditors and their fee determined by Bank concerned with approval of Central Government.

## Auditor's Report

For *Nationalised Bank*, Report to Central Government stating :

(i) Balance Sheet is full and properly drawn up and True and Fair View.
(ii) Transactions of Banks within their powers.
(iii) Returns received from offices and branches of Banks are adequate.
(iv) P & L A/c. shows true balance of profit or loss.

For *Banking Companies*, in addition to reporting u/s 227, also to state whether –

(i) Information and Explanations are satisfactory.
(ii) Transactions of company within power of company.
(iii) Returns received from branches are adequate.
(iv) P&L shows true balance of profit or loss.
(v) Any other matter to be brought to notice of the share holders of the company.

## 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 of Management and RBI.

→ ***Examination of 2 Aspects***

(i) Correctness of figures of DTL (Demand & Time Liabilities) on reporting Friday (last Friday of second preceding fortnight), and
(ii) Maintenance of liquid asset on selected date.

**Steps :**

i. See circulars of RBI regarding composition of DTL;
ii. Branch auditor to verify correctness of cash on 12 odd dates (Br. Not maintain assets / securities);
iii. Review Return from un-audited branches.
iv. It is examination on test basis consolidation regarding DTL position prepared by the Bank.
v. Examine exclusions and inclusions from / in the liabilities.
vi. Verify computation of liquid Assets and following are treated as cash :
   (a) Deposits with RBI by Banking Company incorporated outside India.
   (b) Cash/Balance by Banking Companies with itself or with RBI.
   (c) Balance maintained by Scheduled Bank with RBI in excess of balance required to be maintained.
   (d) Net Balance in current A/c. in India by Scheduled Bank.
   (e) Balance by RRB with Sponsor Bank.
vii. Price of gold shouldn't exceed current market price.
viii. Verify amount of unencumbered approved security.
ix. Provision for Expenses and Liabilities not to be included in DTL.
x. Number of unaudited branch and reliance on returns, etc. to be disclosed by central statutory auditor in his report.

## CAPITAL ADEQUACY

"Adequacy of capital resources of a Bank in relation to risks associated with its operation" All Indian scheduled commercial Banks (excluding RRB) & foreign Banks operating in India to maintain CA Ratio at a minimum of 10%. Banking operations are risky thus it is more appropriate for a bank to maintain adequate capital funds corresponding to risk associated with its operations.

From 1st November 04 public sector bank require to maintain it at 9% and private sector bank at 10%.

$$\text{Capital Adequacy Ratio} = \frac{\textit{Capital funds}}{\textit{Risk wto assets \& off B/S Items}} \times 100$$

⇒ Capital Funds

**(1) Tier I Capital** **=** (Paid up capital + St. reserve + disclosed free Reserves)

(Equity investments in subsidiary + Intangible Assets + current & B/f loss)

**(2) 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 after exposing to varying degrees of risk as specified.

## CONCURRENT AUDIT

"Audit or verification of transactions or activities of an organisation concurrently as the transaction or activity takes place."

⇒ It is done on regular Basis.

⇒ Mandatory for Banks to cover at least :

(i) 50% of total deposits &

(ii) 50% of total advances

⇒ Following should be considered :

(i) Large / very Large branches

(ii) Special branches

(iii) Large problem branches

(iv) H.O. department dealing with treasury/funds management & handling Investment Portfolio.

(v) Any other branch/deptt. at discreation of bank

⇒ It can be undertaken by internal inspection staff or outside C.A.

⇒ **Scope of Concurrent Audit :**

Daily Cash Transactions, purchase & sale of share & securities physical verification, procedure for opening new A/c Verification of Advances, foreign Exchange Transaction, House keeping (Reconciliation. Balancing of ledger etc.) , Determination of revenue Leakage, fraud prone areas, High Value transactions, Safe custody of security form, T.D.S., statement, H.O. return etc., study of RBI Report & Inspection Report dealing with customers complaints.

⇒ Its objective is to see whether transactions or decisions are within the policy parameters valid down by H.O., they don't violate instructions of RBI & they are within authority.

⇒ Remuneration of auditor is fixed by bank.

⇒ Minor irregularities to be rectified on the spot. Serious irregularities reported to H.O. /Z.O.

⇒ Proper reporting & at proper interval. Reported on $10^{th}$ of next month/quarter but flash report can be submitted immediately,

## Audit Committee

⇒ **Member :** Executive director, nominee of Central Govt. & RBI, CA director & one of non-official directors

⇒ Review Internal inspection/ appointment & Remuneration of Concurrent Auditor/ Conducting training Programmes etc.

## Norms For Investment

⇒ Banks to frame suitable Investment policy.

⇒ Classification of Investment

- Held to maturity
- Available for Sale
- Held for Trading

⇒ Disclosure in A/c same as present 6 categories.

## Held To Maturity

⇒ Intention Basis.

⇒ HTM $\leq$ 25% of Banks total Investment.

⇒ Following not to be Covered /Counted for 25%

(i) Re-capitalisation Bonds from govt. of India.
(ii) Investment in subsidiary & Joint Venture.
(iii) Investment in Debenture/Bonds if deemed to be in nature of advance

- If issued for project finance (3 Yrs. or more)

  Or

  If issued for working capital finance (less than 1 yr.)

  and

- Banks state is $\geq$ 10% is issue.

  and

- Issue is part of private placement.

⇒ Profit on sale of such I to P&L A/c & thereafter Capital Reserve A/c. Loss to P&L A./c.

⇒ Carried at acquisition cost. If acquisition Cost is more than face value there amortise the premium. Recognise permanent dimunation.

## Held For Trading

(i) Intention to trade for short term price/Interest rate gain

(ii) to be sold within 90 Days

(iii) Profit or loss on sale to P&L A/c

(iv) Marked to Market at Monthly/Frequent intervals.

## Available for Sale

(i) If not is above 2 categories.

(ii) Profit or Loss on sale to P/L A/c.

(iii) Valuation ➔ Individually script-wise Marked to Market at quarterly/frequent interval.

(iv) Dept. to be Provided (appreciation ignored) Debit to P&L A/c & equivalent amt. To be transferred from I Fluctuation Reserve A/c to P&L A/c.

## INVESTMENT FLUCTUATION RESERVE

(i) minimum 5% of investment within 5 years (only w.r. to held for trading and available for sale)

(ii) Maximum upto 10% of Portfolio

(iii) Transfer maximum amount of gains realised on sale of Investment in Securities to Investment Fluctuation Reserve (IFR)

(iv) IFR eligible for inclusion in Tier-2 Capital.

(v) Transfer to IFR as appropriation to net Profit “below line” after statutory Reserve.

**Shifting among categories of I**

(i) To / from HTM ➔ Approval of BOD. Shifting can take place once a year at beginning of year.

(ii) From AFS to HFT ➔ with approval of BOD / ALCO/ Investment Committee.

(iii) From HFT to AFS ➔ Generally not allowed only in exceptional situation with permission of BOD / ACCO / I Committee.

(iv) Transfer at acquisition Cost / Book value / Market value on date of Transfer (least) depreciation provided for.

**Income Recognition on I :**

(i) Accrual Basis on securities if guaranteed by Central govt.

(ii) Otherwise if owners right is established.

(iii) From mutual funds on cash Basis.

**Broken period Interest**

Banks not to capitalize BPI paid to seller as part of cost but treat as exps. in P&L A/c.

**CDR (Corporate Debt Restructuring)**

(i) For corporate debt of entities facing problems which are outside purview of BIFR etc.

(ii) Apply to multiple Banking A/c etc. with O/S exposure of 10 crore or more.

(iii) Provision for sacrifice of Interest at H.O. Books.

**SOME IMPORTANT MATTERS TO BE CONSIDERED BY AUDITOR**

**Bills for Collection**

1. All documents accompanying the bill should be received and entered in the register by a proper officer.
2. The accounts of the principals should be credited only after realisation of the bill.
3. It should be ensured that bills sent by one branch to another branch for collection are not included twice in the amalgamated balance sheet.

**Bills Purchased**

1. At the time of purchase of the bills, an officer should verify that all documents of title are properly assigned to the bank.
2. Sufficient margin should be kept while purchasing or discounting of a bill.
3. All irregular outstanding accounts should be periodically reported to the head office.
4. Incase of purchase or discounting of a bill, proportionate income should be recognized between the periods.

**Credit Card Operations**

1. There should be effective screening of applications with reasonably good credit assessment.
2. There should be strict control over storage and issue of credit cards.

3. The system whereby the merchant confirms the unutilized balance *of* the customer With the bank before accepting payment should be properly installed.
4. There should be a system *of* prompt reporting by the merchants *of* all settlements accepted by them through credit cards.
5. All the reimbursements should be immediately charged to the customer's account.
6. Items overdue beyond a reasonable period should be identified and attended to carefully.

6. There should be a system *of* periodic review *of* credit card holder's accounts.

**LOANS :**

1. Loan documents to be check.
2. Check the securities hypothecated against loan.
3. Check the internal control, procedures for loans applied by the bank.
4. Whether loan agreements (sanction limits) within authority of bank.
5. Whether bank is properly following up the loan.
6. Check NPA and their provisions.
7. Interest calculations.
8. Whether there is healthy turnover in account.
9. Whether repayment schedule is made considering repayment capacity of borrower.
10. If borrower is a company, whether there is proper resolution to borrow amount from bank.
11. Audit of bank borrower.

**REVISED NPA NORMS,REFER TO CHARTS ON THIS TOPIC**

# GENERAL INSURANCE COMPANY

**Applicability of AS to G.I.C. :**

1. AS – 3 → As per Direct Method only.
2. As – 4 → Not applicable w.r.t. liabilities arising out of I. Policies.
3. AS – 9 → Not applicable w.r.t. incomes of insurance business.
4. AS – 13 → As per regulation. Apply AS – 13 where regulation is silent.
5. AS – 17 → Applicable in each case irrespective of its applicability clause.

**Auditors' Report :**

1. (a) obtained all information
   (b) proper books of Ac/. Maintained.
   (c) Proper returns received from branches.
   (d) Balance sheet, revenue A/c., P&L A/c., R&P A/c. in agreement with books.
   (e) Acturial valuation of liability certified.

2. (i) **Opinion on :**
   (a) Balance sheet – true and fair view of affairs.
   (b) Revenue – true and fair view of surplus / deficit.
   (c) P & L – true and fair view of profit / loss.
   (d) R & P – true and fair view of receipt / payment.
   (ii) Financial Statement prepared in accordance with regulation.
   (iii) Investment as per reg.
   (iv) A/c policies appropriate.

3. **Certify that**
   (i) Reviewed management report and no mistake therein.
   (ii) Insurer complied with terms of registration.

4. **Certificate that**
   (i) Verified cash balance and securities.
   (ii) Extent of verification of investment etc., relating to any trust undertaken by insurer as trustee.
   (iii) No asset in contravention of Act.

**Requirement of schedule B to IRD A Regulation 2002**

***Part 1 A/c principles for prep. of financial information***

(i) Applicability of A/c std.
(ii) Premium
(iii) Premium Deficiency
(iv) Acquisition cost (Expand in the period in which incurred)
(v) Claims
(vi) Valuation of Investment
(vii) Loan
(viii) Catastrophe Disaster Reserve

***Part 2: Disclosure***

***Part 3: General Instruction***

(Last year figures, notional income, Provision/Reserve)

***Part 4: Management Report***

- Confirmation for validity of registration
- Conformation that all statutory dues have been paid.
- Conformation that shareholding pattern is in accordance with law.
- Conformation that solvency margin is maintained
- Conformation that valuation of I
- Conformation that management has not invested any money outside India.
- Conformation that overall risk exposure
- Conformation that operation in other countries
- Conformation that aging of claims
- Conformation that quality of asset & portfolio
- Conformation that payment to parties in which director are interested
- Responsibility statement.

## INVESTMENTS

1. Investment in other than approved investment if :
   (i) Such investment ≤ 25% of total investment; and
   (ii) Consent of all Directors.
2. Insurer not to invest in one insurance / investment company exceeding –
   (i) 10% of total asset of insurer; or
   (ii) 2% of share capital/debenture of company concerned.

   For other companies (other than insurance / investment company) 2% is replaced by 10%.
3. Funds of policy holders not to be invested outside India.
4. Every insurer to keep at all times

| | | |
|---|---|---|
| (i) | at least 20% of Assets | Central Govt. Securities. |
| (ii) | at least 30% (including (i) | State Govt. and other guaranteed securities |
| (iii) | at least 5% of total assets | Housing & loan to State Government |
| (iv) | at least 10% of total assets | in approved securities under infrastructure / social sector. |
| (v) | upto 55% | Other securities. |

***Guidelines***

(ii) Proper Balance between infrastructure and social sector.
(iii) Based on rating of assets.
(iv) Rating by independent agency
(v) Should be at lest “A A” grade.
(vi) In shares in actively traded / liquid investment.

***Valuation of Investment***

(i) ***Real Estate –*** Investment property : Historical cost less acc. Dep. Less impairment loss. Residual value as zero.

(ii) ***Debt Securities –*** as ‘held to maturity’ – Historical cost.

(iii) ***Equity / Derivative Active Market –*** F.V. at B/S date. Impairment as exps. Changes in F.V. in “Fair Value change A/c.”

(iv) ***Unlisted and other –*** at H.C. provision made for diminution in value such provision may be reversed but increased carrying amount not to exceed its historical cost.

### VERIFICATION

***Premium***

⇒ Credited to separate Bank A/c.

⇒ No Risk Assumption without receipt of premium.
Three types of premium – for direct business for re-insurance business and share of co-insurance premium.

⇒ Recognised over policy period. As per risk pattern. Some portion of premium allocable to succeeding period thus called unearned premium.

⇒ Reserve for unexpired risk.

⇒ Premium deficiency = expected cost – related unearned premium. Provision to be made.

⇒ Internal controls and procedures.

⇒ Cover notes serially numbered.

⇒ Premium recognition on aforesaid criteria.

⇒ Company not at risk for uncollected premium, short premium, not collected in time, etc.

⇒ Reinsurance → look for all its details.

⇒ Collection after B/S date whether relating to year under audit.

⇒ Co-insurance, company's share of premium.

⇒ Premium register chronologically → in order of time of premium.

⇒ Due date and date of collection.

⇒ Year end transactions.

⇒ Service tax → applied on premium

⇒ Refund of premium.

***Verification of claims***

1. Provision for all unsettled claims.
2. Only for those co. is legally liable.
3. Not exceed insured amount.
4. Event after B/S date.
5. Average clause.
6. Co insurance, provision only for its share.
7. Reasons for long delays after claim lodged.
8. Under litigation, legal advice.
9. Provision net of salvage value.
10. No contingent lia. W.r.t. claim intimated.
11. Intimation within reasonable time.
12. Claim paid duly sanctioned.
13. Claim paid for its share in co-insurance.
14. Claim paid after salvage accounted for.
15. Claim paid discharge note from claimant.

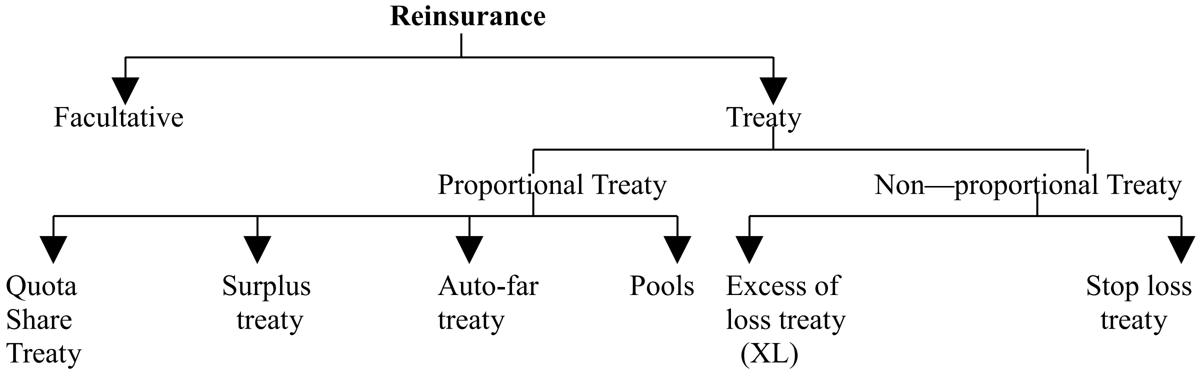
***Unexpired Risk Reserve***

Not all risk expire as on B/S date. Risk will be there in succeeding year w.r.t. premium received in this year, thus provide for –

(i) 50% of all other types and

(ii) 100% for marine Hull.

___ % is to be taken of net premium income i.e. premium received, net of reinsurance premium paid.




⇒ ***Facultative Particular*** risk thus consideration of each risk separately.

⇒ ***Treaty :*** within limits of treaty covering all kinds of risk within treaty..

⇒ ***Proportional Treaty*** → %.

⇒ ***Quota Share*** → fix % of all policies issued under defined slope of business.

⇒ ***Surplus :*** cedes amount which it doesn't want to retain with it.

⇒ ***Auto-far :*** After cession of its surplus treaties.

⇒ ***Pools :*** Members cedes to pool a portion of business directly written by them.

⇒ ***Non-proportional :*** on basis of *loss.*

⇒ ***XL treaty :*** XL on prevent : If more than one risk are affected, limit/loss is arrived at separately.

⇒ ***XL on non-prevent :*** Losses considered on together basis. (Aggregate).

⇒ ***Stop Loss :*** Protect the company from losing more than specified amount for given class of business.

**Solvency Margin :**

To maintain excess of assets over amount of its liabilities at all times, highest of following :

i. 50 crores (100 cr. For reinsurer)

ii. 20% of net premium income.

iii. 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.

**_______ for valuation of Assets :**

→ Zero value to following :

- (i) Agent Bal. & outstanding premium in India not realized within 30 days.
- (ii) Agent Bal. & outstanding premium outside India not realizable.
- (iii) Debts not realizable.
- (iv) Advances.
- (v) Furniture, fixtures, stationery.
- (vi) Deferred expenses.
- (vii) P & L App. A/c.
- (viii) Reinsurer A/c. outstanding for more than 3 months.
- (ix) Preliminary Expenses.

→ Computer Equipment / Hardware / Software.

⇒ Investments as per norms.

- **Commission**

  Commission is the consideration payable for getting the insurance business. The internal control 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:

  - Established guidelines for determining appropriate terms for agency contracts.
  - Appropriate guidelines for calculation of commission.
  - Appropriate system is put in place to ensure timely processing of commission and regular reconciliation of general ledger and premium register.
  - Commission payments are made in accordance with established guidelines.
  - Correlate with this years business.

- **Management Expenses**

  The following internal control measures may be adopted for management expenses

  - Clear management guidelines are issued to cover authorization level of employees / mangers for ordering products and services.
  - Authorized personnel receive products and services only.
  - Purchases should be made only from approved vendors who should selected on the basis of tenders received from them.
  - The management who should also enquire into unusual costs should regularly review work processes and operating expenses.
  - Authorized personnel should release payments only.
  - The company's policy on travel and entertainment expenses should be clearly laid out and communicated.
  - A proper system should be established for complication of employee records, computation of wage bills and disbursement of the same.

- **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.

  - Expenses in excess of Rs.5 lacs or 1% of net premium, which ever is higher, should be shown separately; and
  - Expenses not directly relating to insurance business should be shown separately for example, expenses relating to investment department, bank charges etc.

- **Agents' Balance**

  The audit procedures, which may be followed with regard to agent's balance, are as follows –

  - Verify whether agent's balances and outstanding balances in outstanding premium account have been listed, analysed and reconciled for the purposes of audit.
  - Verify whether recoveries of large outstanding have been made in post audit period.
  - Verify whether there is any old outstanding debit or credit balances as at the year end which require adjustment. A written explanation maybe obtained from the management is to their nature.

- Verify that agents balances do not include employees' balances and balances of other insurance companies.
- Verify that no credit of commission is given to agents for businesses directly procured by it.
- Vouch adjustments / payments against old outstanding balances in agents account.
- Ensure that the relevant control account in the General Ledger is reconciled with the subsidiary records.

➢ **Taxation**

The procedures to be adopted by the auditor while auditing provision for taxation are given below –

- The auditor should check whether provision for taxation has been made after taking into account the specific provisions relating to general insurance companies.
- The auditor should in addition to financial statements examine other accounts furnished by the company to C & AG.
- The auditor should examine the income of foreign branches and foreign countries and the impact of double taxation avoidance treaties.
- The auditor should see that all TDS certificates have been kept and deduction on the same is claimed.
- The auditor should assess the implications of wealth Tax Act, 1957 on the company.
- The auditor should see the system of service tax collection and the payments to statutory authorities and filling of returns.
- The auditor should examine sale tax implications on sale of salvage.

➢ **CO-INSURANCE**

(i) Large business risks are shared between more than one insurer.

(ii) The leading insurer issues the documents, collects premiums and settles claims and renders statements of Accountants to the co-insurers.

(iii) The auditor should check that the premium account is credited on the basis of statements revived from the leading insurer.

(iv) Auditor should check the communication in the post audit period and obtain a written confirmation to the effect that all incoming advice have been accounted for.

(v) The claims provisions and claims paid should also be verified.

(vi) For outgoing co-insurance the auditor should scrutinize the transactions relating to outgoing business; i.e. where the company is the leader.

➢ **Verification of Reinsurance Inwards**

- The Reinsurance inward underwriting should be as per the norms and guidelines prescribed in the Insurance Act, 1938 IRDA Regulations as well as the company's approved programme.
- The auditor should verify the reinsurance inward transactions are as per the arrangements with re-insurers.
- The auditor should examine the accounting policy of the company in regard to reinsurance business received, premium received and payment of commission and claim costs.
- The auditor should satisfy himself about the system of control over the reinsurance inward programme.
- The auditor should examine the foreign currency transactions and ensure that they comply with Accounting Standards (AS) 11, Accounting for Effects of Changes in Foreign Exchange Rates.
- The auditor should examine whether the outstanding claim figures have been properly obtained well in time, under proper arrangements and adequate provision has been made for outstanding claims.

- The auditor should check whether provision has also been made for claims incurred but not reported.
- Closing balance of the re-insurer's accounts should be reconciled and confirmation should be obtained form them.

➢ **Verification of Reinsurance Outward**

The auditor should apply the following verification measures for reinsurance outward transactions

- The auditor should verify that reinsurance outward transactions are as per the norms and guidelines prescribed in the Insurance Act, 1938, IRDA Regulations and company's approved reinsurance programme.
- The auditor should verify that insurances have been ceded as per agreements entered into with various companies.
- The auditor should verify the confirmations received form re-insurers regarding claims for losses submitted to them.
- The auditor should examine the aspects of reinsurance cession premium, commission receivable, paid claims- recovered, outstanding losses- recoverable from re-insurers.
- The auditor should examine the foreign currency transactions and ensure that they comply with Accounting Standard (AS) – 11.
- The auditor should set whether the sub-ledger balance tallies with general ledger control account. He should also scrutinize selected accounts of re-insurers.
- He should verify any old outstanding claims paid or outstanding at the end of the year.
- The auditor should look into events after balance sheet date which might have significant impact on recovery of claims – paid or outstanding.

# COST AUDIT

Cost Audit comprise ;

(i) Verification of Cost Account records, and

(ii) Examination of these records to ensure that they adhere to Cost Accounting principles, plans, procedures and objectives.

**Types of Cost Audit**

(1) ***On behalf of management :***

- (i) Establishing accuracy of cost data
- (ii) Whether objectives of Cost Account being achieved.
- (iii) Abnormal losses and gains with causes.
- (iv) Determine unit cost of production
- (v) Proper overhead rates.
- (vi) Fixation of contract price.
- (vii) Improving quality of Cost Accounting System.

| | | |
|---|---|---|
| (2) ***On Behalf of a Customer*** | : | For Cost plus contracts |
| (3) ***On Behalf of Government*** | : | For subsidies etc., may be to determine fair price. |
| (4) ***By Trade Association*** | : | Maintenance of a price. |
| (5) ***Statutory Cost Audit*** | : | U/s. 233 B of the Companies Act |

Under-noted circumstances may also warrant the introduction of Cost Audit :

(i) Price fixation, (ii) Cost variation within the industry, (iii) Inefficient management

(iv) Tax assessment (v) Trade dispute.

**Advantage of Cost Audit**

| **To Management** | **To Society** | **To Shareholder** | **To Government** |
|---|---|---|---|
| 1. reliable data<br>2. check on wastage<br>3. inefficiency & corrective action<br>4. MBE<br>5. Budgetary control & Standard Costing<br>6. Valuation of closing stock<br>7. detection of error and fraud | 1. Fixation of Price<br>2. Justification of price increase by increase in cost of production | Proper records are kept for material, wages, etc. | 1. Cost plus contract<br>2. Ceiling price<br>3. Inefficient unit.<br>4. Protection to certain industries<br>5. Settlement of Trade dispute.<br>6. Healthy competition among units in industry. |

*General features of Cost Records*

(ii) **Materials**→ Raw material, processed material, consumable stores, etc.
→ Purchased, issued and balance.
→ Cost to include all direct charges upto works.
→ Separate records for wastage, spoilage losses, etc.
→ Method to adjust the loss.
→ Method of valuation actual or standard costing.

(iii) **Manufactured components & Intermediaries :**
→ Separate records
→ Quantity and value
→ Wastage

(iv) **Stores and Spare Parts :**
→ Receipt, issues and balances.
→ Quantity and value.
→ All direct charges upto works
→ Used should be charged to relevant head.
→ Wastage separately shown.

(v) **Wages and Salaries :**
→ Proper Records to show attendance and earnings.
→ Records to show overtime wages, piece rate wage earned, incentive wages and earnings of casual labourer.
→ Idle time.
→ Extent of wages and salaries capialised.

(vi) **Overheads :**
→ Proper maintenance of records.
→ Classified under works, Administration and selling and distribution overheads.
→ Allocation of or. to deptt., etc.
→ If allocation on method other than actuals the variation and its treatment.

(vii) **Service deptt. Expenses including Expenses on utilities :**
→ Expenses on power, fuel, water and steam (purchased or generated)
→ Expenses on subsidized canteen.
→ Maintenance deptt. Expenses.
→ Allocation on reasonable basis.

(viii) **Depreciation :**
→ Cost, date of installation, rate of depreciation, and amount of depreciation provided.
→ Old assets.
→ Minimum rate of depreciation in Company Act.
→ AS-6.

(ix) **Packing :** → Quantity and cost of packing material.
→ Wages and other expenses on packing.
→ Income received by sale/disposal of spoiled, rejected waste materials.

(x) **By-products :**
→ Proper records.
→ Receipt, issues and Balances (quantity and value).
→ Basic of Valuation.
→ Sales realization.
→ Expenses on further process of by-product.

(xi) **Production and Sales :**
→ Records (quantity and value)

→ Separate records of packed and unpacked finished goods.
→ Records of Sales and inventory.

(xii) **Inventories :** → Classified as raw materials, stores and spare parts WIP and finished goods.

→ Separate records (quantity and value).
→ Physically verified.
→ Reasons for shortage and excess.
→ Method to determine cost of WIP and finished goods.
→ Methods to be followed consistently.

(xiii) **Variances :** → If Standard Costing i.e. other than actuals then procedure followed to work out cost of the products.

→ Reasons for variances.

(xiv) **Cost Statements :**

→ As part of cost records.
→ w.r.t. each product.
→ Form of cost sheet (prescribed).

(xv) **Reconciliation of Cost and Financial Account :**

→ To ensure accuracy.
→ Variations clearly indicated an explained.
→ Period of reconciliation $\leq$ financial year of company.
→ Difference between sales realization and total cost and then it is reconciled with financial P&L A/c. for the period.
→ Specific information in Both A/c. not to be different.

(xvi) **Royalty :** → Records of Royalty paid.

→ With terms of agreement.
→ Basis of computation.
→ Allocation to different cost centers, etc.
→ If it is a direct charge or overhead.

(xvii) **Statistical Records :**

→ Plant utilization, idle machine time, capital employed, capital W.I.P.
→ Percentage of different raw materials.
→ To have control over various operations and costs.

(xviii) **Inter – Company transfer :**

→ Normally, no inter co. transfer below cost.
→ Ensure against shifting of profits between corporate investors.
→ Proper valuation of inter-company transfer to generate revenue (duty and tax).

**Programme of Cost Audit**

(c) Review of Cost Accounting Records : This will include :

i) Method of costing in use – batch, process or unit.
ii) Method of accounting for raw materials; stores and spares, wastages, spoilage defectives, etc.
iii) System of recording wages, salaries, overtime and spares, wastages, etc.
iv) Basis of allocation of overheads to cost centers and of absorption by products and apportionment of service department's expenses.
v) Treatment of interest, recording of royalties, research and development expenses, etc.
vi) Method of accounting of depreciation.
vii) Method of stock-taking and its valuation including inventory policies.
viii) System of budgetary control.
ix) System of internal auditing.

(d) Verification of cost statements and other data. This will include the verification of :

i) Licensed, installed and utilized capacities.
ii) Financial ratios.
iii) Production data.
iv) Cost of raw material consumed, wages and salaries, stores, power and fuel, overheads provision for depreciation etc.
v) Sales realization.
vi) Abnormal non-recurring and special costs.
vii) Cost statements.
viii) Reconciliation with financial books.

**Exemption from Cost Audit**
The exemption from Cost Audit on year-to-year basis in the following situation :
(i) Temporary Closure of the company/products.
(ii) Negligible production activity.

***Fees :***

| | Company having an authorized Capital | Amount of fees to be paid |
|---|---|---|
| A | Less than Rs.25 lakh | Rs. 500 |
| B | Rs.25 lakh or more but less than Rs.5 crore | Rs.1,000 |
| C | Rs.5 crore or more | Rs.2,000 |

Appropriate documents are required to be furnished along with application for exemption :
(i) True copy of complete Annual Report containing balance sheet and profit and loss account for the year for which exemption is being sought along with copies of the same pertaining to preceding two years.
(ii) An affidavit containing full facts of capacity utilization turnover and financial status of the company, duly signed by two Directors of the company and authenticated by a Notary Public.
(iii) A brief note/status report on steps taken by the management for revival of the said unit.

**Steps in Cost Audit**

**Review** → verification of cost data → Refer to financial statement → Reporting.

**Cost Audit Report**
Within 180 days of end of F.Y. to Central Government. A copy to company whether –
(iii) All information
(iv) Proper Cost Account records as required.
(v) Proper returns from Branches.
(vi) Books give information in manner so required.
(vii) Cost statement as specified in annexure are kept by company.
(viii) In his opinion, true and fair view of cost.

**Auditor's observation and suggestions ;**
(i) Adequacy or otherwise of Cost Accounting System and suggestions for improvement thereof.
(ii) Adequacy or otherwise of Budgetary control system, if any.
(iii) Matters clearly wrong in principle.
(iv) If price charged for related party transactions is different from normal price and its impact.
(v) Areas of decline profitability or loss with reasons, including default on payment to Government, F.I. and Banks, etc.

(vi) Steps required under competitive environment.
(vii) Export commitments vis-à-vis actual exports.
(viii) Scope of internal audit of records and its adequacy, etc.

**True and fair cost of production :**

(iv) Accepted Cost Accounting principles.
(v) Costing system appropriate to product.
(vi) Materiality.
(vii) Consistency.
(viii) Prescribed form.
(ix) Elimination of prior period adjustments.
(x) Abnormal losses ignored in determination of cost.

**Composite Audit**

It is not feasible due to :

(i) Different information system (accounting data / costing data).
(ii) Objective of Audit. (True and Fair financial statement Vs. Cost).
(iii) Classification of accounting data (A/c head vs. Cost centres).
(iv) Confidentiality. (Cost Audit Report is more confidential).
(v) Applicability (for all Co. vs. Some Industries).
(vi) Tool of Management (overall results vs. weaknesses in cost the system)
(vii) Extensive Nature: (cost auditor also on propriety & efficient aspects).

## Annexure to Cost Audit Report

(1) General.
(2) Cost Accounting System
(3) Process of manufacture.
(4) Quantitative Details (*).
(5) (A) Major Input Materials / Components Consumed (*).
 (B) Standard / Actual consumption of input material per unit.
(6) Break-up of cost of input materials imported during the year (*).
(7) (A) Power, fuel and utilities (*).
 (B) Standard / Actual consumption of power, fuel and utilities in terms of quantity per unit of production.
(8) Salaries and wages (*).
(9) Repairs and Maintenance.
(10) Fixed Assets Register and Depreciation.
(11)Gross Block, Depreciation and Lease Rent.
(12)Overheads (**)
(13)Research and Development Expenses (**)
(14)Royalty and technical know how charges (**)
(15)Quality Control Expenses (**).
(16)Pollution Control Expenses (**).
(17)Abnormal non-recurring costs (**)
(18)(A) Non-moving stock at end of the year (**)
 (B) Written off stock during the year (**)
(19)(A) Inventory valuation at end of the year.
 (B) Physical verification of stock.
(20)Sales of product under reference (quantity, rate amount for current and previous year).
(21)Margin per unit of output (*)
(22)Competitive margin against imports (**)
(23)Value Addition and Distribution of earnings (**).
(24)Financial position and Ratio Analysis (**).

(25)Capitalisation of Revenue Expenditure (**).
(26)Related party transactions.
(27)Central Excise Reconciliation for product under reference.
(28)Profit Reconciliation.

---

* *Data for current year 1st previous year and 2nd previous year.*
** *Data for current and 2 previous year for product under reference and for factory as a whole.*

# AUDIT REPORT

**TRUE AND FAIR :** Financial statements are reported to be as true and fair when all of the following hold good -

- Reasonable evidence is obtained in support of the transactions recorded in the books of account;
- Accounting entries passed in the books of account are in conformity with the applicable accounting principles and standards followed consistently;
- The financial statements prepared represent a true summary of transactions that took place during the year;
- 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;
- The accounting statements do not contain any misstatement;
- The material transactions recorded in the books are neither illegal nor beyond the legal powers of the client; and
- All statutory and relevant disclosures have been made**.**

## ➢ AUDIT REPORTS UNDER COMPANIES ACT, 1956

- **Report under section 227 (1A)**

  Section 227 (1 A) requires the auditor to make **specific enquiries** during the conduct of his audit. He is, however, <u>not required to report on these matters unless he has any special comments to make</u>. 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 and whether the terms on which they have been made are not prejudicial to the 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 within the meaning of section 372 or a banking company, whether so much of the assets of the company as consists 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.

- **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 balance sheet, of the state of the company's affairs as at the end of its financial year; and
  - in the case of the profit and loss account, of the profit or loss for its financial year.

- **Report under section 227(3)**

  The auditor's report should state
  - Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit;
  - Whether in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books, and proper returns for the purposes of his audit have been received from branches not visited by him;
  - Whether the report on the accounts of any branch office audited under section 228 by a person- other than the company's auditor has been forwarded to him as required by clause (C) and how he has dealt with the same in preparing his report;
  - Whether the company's Balance Sheet and Profit and Loss Account dealt with by the report are in agreement with the books of accounts and returns;
  - Whether, in his opinion, the Profit and Loss Account and balance sheet complied with the accounting standards referred to in section 211 (3c);
  - Whether any director is disqualified from being appointed as a director under section 274(1).
  - Whether any cess payable by the company has been so paid and if not the amount not so paid.

The companies (Second Amendment) Act, 2002 provides for section 441A which states as follows:

**(i)** A cess on companies will be levied for purpose of rehabilitation or revival of sick industrial Co.

**(ii)** These provisions are made in sections 441A to 441F.

**(iii)** The amount to be collected must be in a range of .005% to .1% on value of annual turnover annual gross receipts more as the Central Government may notify from time to time in official gazette.

**(iv)** The company shall pay the amount to Central Government within 3 months from close of every financial year.

- **Report under section 227 (4A)**

**COMPANIES (AUDITOR'S REPORT) ORDER, 2005**

➢ **Short title, application and commencement**

- This order may be called the Companies (Auditor's Report) Order; 2005.
- It shall apply to every company including a foreign company as defined in section 591 of the Act, except the following –
  - a Banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 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 twenty five lakh rupees or more from any bank or financial institution and does not have a turnover exceeding five crore rupees.

➢ **Definitions -** In this Order, unless the context otherwise requires

- "Act" means the Companies Act, 1956 (1 of 1956);
- "chit fund company", "nidhi company" or "mutual benefit company" means a company engaged in the business of managing, conducting or supervising as a foreman or agent of any transaction or arrangement by which it in into an agreement with a number of subscribers that every one of them shall subscribe to a certain sum of instalments for a definite period and that each subscriber, in his turn, as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement, shall be entitled to a prize amount, and includes companies whose principal business is accepting fixed deposits from, and lending money to, members;
- "finance company" means a company engaged in the business of financing, whether by making loans or advances or otherwise, of any industry, commerce or agriculture and includes any company engaged in the business of hire-purchase, lease financing and financing of housing;
- "investment company" means a company engaged in the business of acquisition and holding of, or dealing in, shares, stocks, bonds, debentures, debenture stocks, including securities issued by the Central Government or by any local authority, or in other marketable securities of a like nature.
- "Manufacturing company" means a company engaged in any manufacturing process as defined in the Factories Act, 1948 (63 of 1948);
- "Mining company" means a company owing a machine, and includes a company which carries a the business of a mine either as a lessee or occupier thereof;
- "Processing company" means a company engaged in the business of processing materials with view to their use, a sale, delivery or disposal;
- "Service company" means a company engaged in the business of supplying, providing, maintaining and operating any services, facilities, conveniences, bureaux and the like for the benefit of others;
- "Trading company" means a company engaged in the business of buying and selling goods.

➢ **Auditor's report to contain matters specified in paragraphs 4 and 5** - Every report made by the auditor under section 227 of Act, on the accountants of every company examined by him to which this Order applies for every financial year ending on any day on or after the commencement of this Order, shall contain the matters specified in paragraphs 4 and 5.

➢ **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–

(i) Whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;

- Whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
- If a substantial part of fixed assets have been disposed off during the year; whether it has affected the going concern;

(ii) Whether physical verification of inventory has been conducted at reasonable intervals by the management; .

- 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;
- 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 accounts;

(iii)▪has the company granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and amount involved in the transactions.

- 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;
- Whether receipt of the principal amount and interest are also regular;
- If overdue amount is more than one lakh, whether reasonable steps have been taken by the company for recovery of the principal and interest;
- Has the company taken any loans, secured or unsecured from companies, firms or other parties covered in the register maintained u/s. 301 of the Act. If so, give the number of parties and the amount involved in the transactions.
- 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.
- Whether payment of the principal amount and interest are also regular.

(iv) is there an adequate internal control system commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods and services. Whether there is a counting failure to correct major weaknesses in internal control system.

(v) ▪ Whether the particulars of contract or arrangements referred to in section 301 of the Act have been entered in the register required to be maintained under the section.

- Whether the transactions made in pursuance of such contracts or arrangements have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time;

  (This information is required only in case of transactions exceeding the value of five lakh rupees in respect of any party and in anyone financial year).

(vi) in case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of sections 58 A and 58AA or any other relevant provision of the Act and the rules framed there under, where applicable, have been complied with. If not, the nature of contraventions should be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or RBI or any Court or any other Tribunal whether the same has been complied with or not?

(vii) in the case of listed companies and / or other companies having' a paid-up capital and reserves exceeding Rs.50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crore rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business;

(viii) where maintenance of cost records has been prescribed by the Central Government under clause (d) of sub-section (1) of section 209 of the Act, whether such accounts and records his been made and maintained;

(ix) ▪is the company regular in depositing undisputed statutory dues including Provident Fill Investor Education and Protection Fund, Employees' State Insurance, Income-tax, Sales-tax, Wealth Tax, Service Tax, Custom' Duty, Excise Duty, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall De indicated by the auditor.

- In case dues of sales tax *1* income tax *1* custom tax *1* wealth tax *1* excise duty *1* cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending may please be mentioned.

  (A mere representation to the Department shall not constitute the dispute).

(ix) Whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty percent of its net worth and whether it ha incurred cash losses in such financial year and in the immediately preceding financial year.

(xi) Whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported;

(xii) Whether adequate documents and records are maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities; If not, the deficiencies to be pointed out.

(xiii) Whether the provisions of any special statute applicable to chit fund have been duly complied with? In respect of nidhi / mutual benefit fund / societies;

- Whether the net-owned funds to deposit liability ratio is more than 1 : 20 as on the date of balance sheet;
- Whether the company has complied with the prudential norms on income recognition and provisioning against substandard *1* doubtful / loss assets;
- Whether the company has adequate procedures for appraisal of credit proposals *1* requests, assessment of credit needs and repayment capacity of the borrowers;
- Whether the repayment schedule of various loans granted by the night is based on the repayment capacity of the borrower.

(xiv) If the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein; also whether the shares, securities, debentures and other securities have been held by the company, in its own name except to the extent of the exemption, if any, granted under section 49 of the Act;

(xv) Whether the company' has given any guarantee for loans taken by others from bank or financial institutions; the terms and conditions whereof are prejudicial to the interest of the company;

(xvi) Whether term loans were applied for the purpose for which the loans were obtained;

(xvii) Whether the funds raised on short-term basis have been used for long term investment; if yes, the nature and amount is to be indicated;

(xviii) Whether the company has made any preferential allotment of shares to parties and companies covered in the Register maintained under section 301 of the Act and if so whether the price at which shares have been issued is prejudicial to the interest of the company;

(xix) Whether securities or charge have been created in respect of debentures Issued?

(xx) Whether the management has disclosed on the end use of money raised by public issues and the same has been verified;

(xxi) Whether any fraud on or by the company has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

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

b. **Auditor should consider following while rendering modified report**

   i. The auditor should identify the statements of facts and opinions, which require qualification.

   ii. 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.

   iii. Where the disagreement with the management is only in respect of a particular item, he may qualify his report.

   iv. Where the item is material enough to distort the true and fair view of *state of* affairs of the company, he may give an adverse opinion in respect of such item.

   v. Where the item concerned is not material, he may even ignore the aspect and issue a clean report.

## ➢ AUDITOR'S SEPARATE REPORT TO DIRECTORS

1. The management of the company may require from the auditor a separate report in addition to his report under section 227 of the Act.
2. The objective of such reports is to provide the management with detailed information regarding procedures, systems, weaknesses in internal controls etc.
3. Such reports should be detailed enough to highlight the weakness and suggestions to improve.
4. However, 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.
5. Thus, auditor's separate report to director can not be substituted for an otherwise modified report.

## ➢ AUDIT CERTIFICATES AND AUDIT REPORT

1. A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion.
2. The auditors certificate represents that he has verified certain figures and is satisfied about their accuracy.
3. However, a report, is a formal statement made after an enquiry or examination of the specified .matters under the report and the auditors opinion thereon.
4. Thus the opinion may differ from one auditor to another as it involves personal judgement.

## ➢ AUDIT OF COMPANY PROSPECTUSES

According to section 2 (36) of the Companies Act, 1956 '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.

In order to protect the investors from deceiving offers, the Companies Act has specified certain information to be furnished in detail in the prospectuses.

**Reports to supplement the prospectus**

Two reports on financial aspects to be included in a prospectus are

- Reports of the statutory auditor or joint auditors of the company; and

- Report of the accountant.

A person who is eligible to be appointed, as an auditor shall be qualified to act as an accountant.

➢ **Aspects Concerning the Auditor**

- **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.
- **Fees for issue of reports -** The fees for making a report to be attached to the prospectus would be determined on the basis of agreement between the auditor and the directors of the company.
- **Consent Letters -** According to section 60 (3) of the Act, the auditor should give in writing his consent to act in such capacity. The letter should accompany the prospectus when submitted for registration.
- **Liability for misstatements in prospectus -** According to section 62 of the Companies Act, 1956 every person who _as 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 Chartered! Accountants 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.

  However, a professional accountant will not be so liable if he can prove that

  - the prospectus was issued without his knowledge or consent and that on becoming aware of its issue, he forthwith gave reasonable public notice that it was issued without his consent; or
  - he withdrew his consent in writing before delivery of the prospectus for registration; or
  - after the 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 the statement and that he had reasonable ground to believe and did upto the time of allotment of shares or debentures believe that the statement was true.
- **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.
- **Communication of the report –** The reports of auditors are addressed to the Board of Directors of the company.

➢ **Aspects Concerning the Accountant**

The reporting accountant is 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 –

- All prior items should be adjusted in the year to which they relate and not in the year in which they came to be known;
- All items of material nature which are 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 / business; or
  - Abnormal losses

- 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.
- 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.

With preparing the report to be included in the prospectus, the accountant takes up great responsibility. Thus he should take a note of

- The manner in which the directors, in their estimate of current and future profits, have dealt with the figures shown in the accountant's report and with the matters to which the directors' attention was drawn in that report;
- Material facts known to him, in relation to directors' estimates;
- The manner in which the directors have dealt with any special circumstance.
- Various certificates and representations submitted to him by the management.

In case there is a misstatement in his report and a liability to compensate a person for loss incurred as a result of the misstatement arises, the accountant can protect himself from such liabilities in the manner as discussed for the statutory auditors.

## ➢ AUDIT REPORTS / CERTIFICATES ON FINANCIAL INFORMATION IN OFFER DOCUMENTS

SEBI has been issuing several guidelines for disclosure and investor protection, which include certain financial information to be disclosed. This is in addition to information required as per schedule II to the Companies Act, 1956. This information is required to be audited by a Chartered Accountant.

**Requirement regarding audit of financial information in offer documents:**

Para 4 of Part A-1 of clarification XIV requires that all financial information forming part of offer documents shall be audited. The following are the various financial information which form parts of offer documents.

**1. 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.

**Adjustments in statement of profit or loss and assets and liabilities:**

Clause 20 *at* Part HI of Schedule II to the Companies Act, 1956 requires that "any report required under Part II of this schedule shall either (i) 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 (ii) 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.

**Extraordinary Items**

Profit or loss arrived at before and after considering the extraordinary items should be disclosed. The disclosure of such item should be on "net of tax basis".

**2. 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 financial statements. For example,

- Discontinuance of lines of business.
- Loss of agencies or market and other similar factors.
- Addition of new lines of business.

It is not intended to identify the impact of each change which is part of normal business activities e.g. updating the technology, normal change in product mix, change in ordinary agency relationship. The intention is to identify the changes, which pertain to separate major 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.

- Nature of the discontinued operation
- Effective date of discontinuance for the accounting purposes.
- Manner of discontinuance (sale / abandonment etc.)
- Turnover of the discontinued operation.

**3. Significant Accounting Policies**

All significant accounting policies followed in the preparation of offer document should be disclosed.

**4. Transactions with Companies in "Promoter Group"**

Disclosure in offer document is called for in respect of

- 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.
- Material items of income or expenditure arising out of transactions within the promoter group.

**5. 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, viz.,

- Sources and other particulars of such income
- Indication whether it is recurring or non-recurring and has arisen out of business activities / other than the normal business activities.

The computation of 20% has to be made in relation to net profit or net loss before tax and extraordinary item. The concerned income should be after netting off of expenses, and such netting off is only for computing the relevant "other income". For the purpose of disclosure in the relevant statement of profit or loss the incomes / expenses should disclosed at gross amounts in the usual manner.

The disclosure should be

- Source;
- Nature;
- Amount;
- Recurring or non recurring; and
- Whether on account of normal business activity or not.

**6. Disclosure of Bifurcated Turnover**

- Turnover of products manufactured by the company

- Turnover of products traded by the company and
- Details of products not normally dealt in by the company but included in above should be mentioned separately.

**Financial Information in Respect of which the Auditor should give Separate Report to the Management**

There are 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. The auditor should examine the detailed computations made by the management to arrive at the figure of provisions for taxation, which has been disclosed in the annual accounts.

**(b) Accounting Ratios.**

The following accounting ratios for each of the accounting periods for which financial information is given

- Earnings Per Share
- Return on Net Worth and
- Net Asset Value Per Share
- The auditor should satisfy himself that for making various computations for the above accounting ratios, the various items of profit / loss assets and liabilities have been properly adjusted.
- **Earnings per share**

  It may be (i) basic earnings per share or (ii) diluted earnings per share.

$$\textit{Basic Earnings per Share} = \frac{\textit{Net Proift/ loss for he period attributable to equity shareholders}}{\textit{Weighted average number of equity shares outstanding during the period}}$$

$$\textit{Diluted Earnings Per Share} = \frac{\textit{Net profit attributable to equity shareholders (after adjustment for diluted earnings}}{\textit{Average number of weighted equity shares outstanding during the period (assuming the conversion of diluted potential equity shares)}}$$

Return on Net Worth

The formula used is -

$$\frac{\textit{Net profit before extraordinary items but after adjusted tax}}{\textit{Net worth excluding revaluation reserve at the end of the year}}$$

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**
  - ❖ NAV shall be calculated on the basis of the latest audited balance sheet.
  - ❖ It can be computed either by net assets method or net equity method.
  - ❖ In the case of net asset method the total liabilities and preference capital are deducted from the total assets.
  - ❖ 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.

- ❖ The auditor should consider
  - ✓ Intangible assets are not taken into account (unless they have been paid for)
  - ✓ Revaluation of assets have not been taking into account
  - ✓ 'Arrears of preference dividend should be provided for
- ❖ The formula for NAV per share is

$$\frac{\textit{Net Asset Value}}{\textit{Equity shares at the end of the accounting period}}$$

**(c) 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 the change.

**(d) Disclosure of Project Expenditure**

The following information should be annexed to the Offer Document

- actual expenditure incurred on the project upto a date not earlier than 2 months of filling the prospectus with SEBI or Register of Companies whichever is later
- means and sources of financing such expenditure
- year wise break Lip 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.

**(e) Bridge Loans**

Details of bridge loans or other financial arrangement if any, for incurring expenditure on the project and which would be repaid from the proceeds of, the issue.

**(f) Loans**

The principal terms of loans and assets charged as security should be disclosed.

**(g) Disclosure under "Basic of Issue Price"**

The following information shall be disclosed

- ▪ EPS i.e. EPS pre-issue for the last three years (adjusted for changes in capital)
  - ▪ P/E pre-issue - comparison with PIE of industry (giving source of information) Average return on net worth in the last three years
  - ▪ Minimum return on increased net worth required to maintain pre-issue EPS.
  - ▪ NAV per share after issue and comparison thereof with the issue price.

**(h) Auditor's Certificate on Profit Forecast**

The offer documents should also include a forecast of 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 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.

# DIVIDENDS

*Refer to Chart on Dividend and Case Study from study material.*

## ➢ VERIFICATION OF DIVIDEND

- He should examine the Memorandum and Articles of Association of the Company to determine the rights of different classes of shareholders to whom dividend has been paid.
- He should ensure that dividends can only be distributed out of profits. The capital of the shareholders can not be used for he purpose of payment of dividends.
- 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.
- He should ascertain whether the rate of dividend has been recommended properly in a meeting of the Board of Directors.
- He should inspect the shareholders minute book to verify the amount of dividend declared and confirm that the amount does not exceed the amount recommended by the directors.
- He should see that profits appropriated for payment of divided are after transfer to reserves an amount in accordance with the rules framed by the Central Government.
- He should examine the list of shareholders as drawn from the Registrar of Shareholders and see that the total amount of dividend payable companies with the Dividend Account.
- 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.
- He should verify the amount of unclaimed dividend with the Dividend Account, bank Pass Book and dividend warrants as have been returned undelivered.
- 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 10% is paid with in 14 days from the date of declaration, distribution or payment of dividend whichever is earliest. [Section 115(0) of the Income Tax Act, 1961]
- 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.
- 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.

## AUDITORS DUTY WITH REGARD TO DEPRECIATION

**1.** Companies Act provides only minimum rates. The company can charge depreciation at a higher % also. (or it means lesser life).

**2.** The company can adopt different methods for different type of assets provided the same is consistently followed.

**3.** Change in method of depreciation should be with retrospective effect and only if it is required by statute or accounting standard or if it results in better presentation.

**4.** The accounts must disclose the methods which have been used to calculate depreciation.

**5.** Low-value items may be fully depreciated provided this is disclosed appropriately in the accounts.

6. Depreciation should be calculated from the date when the asset is ready to use.
7. When the asset is installed during the year, check that it is only pro-rate depreciation that appears in the accounts.
8. In case of revaluation of assets, check the depreciation on revalued part (whether charged to Profit & Loss Account or revaluation reserve.

## REFER TO RELEVANT SECTIONS OF COMPANIES ACT FOR DISQUALIFICATION, APPOINTMENT, REMOVAL AND REMUNERATION OF COMPANY'S AUDITOR